

A Minor Dissertation presented in partial fulfilment of the  
Requirements for the Degree of Master of Law in Taxation by  
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TITLE: Establishing the Residency of Artificial Persons in Cross  
Border Transactions

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## DEFINITION OF TERMS

Residence	the act or fact of abiding or dwelling in a place for some time. <sup>1</sup>
Resident	any person who complies with the domestic tax law criteria for residence in a state or country. <sup>2</sup>
Company	any commercial or business entity that is regarded as a person in tax legislation. <sup>3</sup>
SARS	South African Revenue Services.
OECD MTC	Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital 2012.
POEM	Place of Effective Management.
POI	Place of Incorporation.
CM &C	Central Management and Control.
DTA	Double Tax Agreement.
UK	United Kingdom.
TAG	The Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits.
Tax	‘A compulsory levy made by public authorities for which nothing is received directly in return’. <sup>4</sup>

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<sup>1</sup> Webster’s Third New International Dictionary Unabridged 2002 1931.

<sup>2</sup> Art 4 OECD Model Tax Convention on Income and on Capital 2012.

<sup>3</sup> Art 3(2) b OECD Model Tax Convention on Income and on Capital 2012.

<sup>4</sup> Andrew Lymer & John Hasseldine (eds) *The International Taxation System* (2002)2

Tax Treaty

‘An agreement between two countries that outlines a series of provisions which clarify tax rules between countries on specific subjects’.<sup>5</sup>

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<sup>5</sup> Ibid at 124

## Chapter 1

### 1 1 Introduction

The basis of residence taxation is that residents enjoy protection in the state where they contribute towards the costs of government.<sup>6</sup> In tax treaties residence is used for purposes of allocating income and taxing rights between contracting states.<sup>7</sup> For treaty purposes residence is determined on a day to day basis,<sup>8</sup> hence a person can be resident in two countries at concurrent time periods.

It is important to determine the residence of a corporation in a specific jurisdiction for purposes of ascertaining the treaty benefits that the entity can enjoy<sup>9</sup> and the allocation of income between contracting states in a treaty.<sup>10</sup> Usually a company's tax residence is considered to create a sufficient connection with the country that has jurisdiction over it.<sup>11</sup> The recognition of the residence status of natural and juristic persons is the cornerstone of international taxation.<sup>12</sup> Residence is also used as an anti-avoidance tax measure in international tax.<sup>13</sup>

Concurrent Continuous Residence (CCR) gives rise to dual residence.<sup>14</sup> CCR is when two states regard the same person as a resident in their domestic laws during the same period.<sup>15</sup> The problem of double taxation usually occurs when a corporation is a dual resident. Treaties promote single tax residence and dual tax residence is not permissible in tax treaties.<sup>16</sup> Residence tie-breaker clauses are used to eliminate dual residence in tax treaties.<sup>17</sup> A residence tie-breaker clause is a means of allocating taxing

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<sup>6</sup> Lynette Olivier & Michael Honiball *International Tax: A South African Perspective* 5ed (2011) 31.

<sup>7</sup> Robert Couzin *Corporate Residence and International Taxation* (2002) 1.

<sup>8</sup> Olivier & Honiball op cit note 6.

<sup>9</sup> Jonathan Schwarz *Schwarz on Tax Treaties* 2ed (2011) 105.

<sup>10</sup> Reuven Avi Yonah, Nicola Sartori, Omri Marian *Global Perspectives on Income Taxation Law* (2011) 130.

<sup>11</sup> Richard A. Westin *International Taxation of Electronic Commerce* (2000) 559.

<sup>12</sup> Raffaele Russo & Renata Fontana (eds) *A Decade of Case Law: Essays in honour of the 10<sup>th</sup> Anniversary of the Leiden Adv LLM in International Tax Law* (2008) 205.

<sup>13</sup> Raffaele Russo & Renata Fontana (eds) *A Decade of Case Law: Essays in honour of the 10<sup>th</sup> Anniversary of the Leiden Adv LLM in International Tax Law* (2008) 205.

<sup>14</sup> Schwarz op cit note 9 at 116.

<sup>15</sup> Ibid, This arises because of the different residence tests used by states in their domestic laws.

<sup>16</sup> *Swedish Central Railway Co Ltd V Thompson* 1925 (AC) 495.

<sup>17</sup> Art 4(3) of the OECD Model Tax Convention on Income and on Capital 2012, Art 4(3) of the United Nations Model Double Taxation Convention between Developed and Developing Countries 2011.

rights over an entity to a single taxing jurisdiction;<sup>18</sup> it eliminates the problem of double taxation caused by dual residence in international tax.

Although countries are sovereign and have the right to set their own tax rules,<sup>19</sup> the OECD MTC is the precedent for most tax treaties.<sup>20</sup> It is a bilateral treaty and its central purposes are to provide mutual ‘solutions to identical cases of double taxation’,<sup>21</sup> and to clarify the situation of taxpayers who engage in international commercial activity.<sup>22</sup> The Convention is binding on OECD members and is used for reference purposes in negotiations between OECD member and non-member countries.<sup>23</sup> Thus the Model has influence over OECD members and non-members. Although the OECD Commentary is widely accepted as a guide to the ‘interpretation and application of existing tax treaties’,<sup>24</sup> its commentaries are not binding and cannot be considered as rules of international law.<sup>25</sup>

Most tax treaties do not contain explanatory memorandums or commentaries on their various articles and use the OECD Commentaries as an interpretational tool.<sup>26</sup> Article 4(3) of the OECD MTC makes use of the POEM as a residence tie-breaker test in cases of dual residence of non-individual persons. The OECD Commentary on Article 4(3) defines the POEM as;

‘... the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made. All relevant facts and circumstances must be examined to determine

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<sup>18</sup> Commentary on Art 4 of the OECD Model Convention on Income and on Capital 2012 p(C)4-8 para 24.

<sup>19</sup> Oliver R Hoor *The OECD Model Tax Convention : A Comprehensive Technical Analysis* (2010) 43.

<sup>20</sup> Lyman & Hasseldine op cit note 4 at 8.

<sup>21</sup> C Dunahoo ‘Source Country Taxation of Foreign Corporations: Evolving Permanent Concepts’ 2008 40 available at [http://heinonline.org/HOL/Page?handle=hein.journals/taxtm86&div=31&g\\_sent=1&collection=journals#219](http://heinonline.org/HOL/Page?handle=hein.journals/taxtm86&div=31&g_sent=1&collection=journals#219) accessed on 7 August 2013

<sup>22</sup> OECD Model Tax Convention on Income and on Capital 2012 pI-1.

<sup>23</sup> Ibid.

<sup>24</sup> Ibid.

<sup>25</sup> Michael Lang *Tax Treaty Interpretation* ( 2001) 309.

<sup>26</sup> OECD Model Tax Convention on Income and on Capital 2012 pI-4 para 15.

the place of effective management. An entity may have more than one place of management, but can only have one place of effective management'.<sup>27</sup>

Although the OECD Commentaries are used as an interpretational guide in most tax treaties, the Commentary on Article 4 (3) of the OECD MTC fails to provide a clear and consistent interpretation and explanation of the POEM dual residence tie-breaker test. Its interpretation of the POEM does not describe or even state the constituents or type of key management and commercial decisions that have to be considered to establish the POEM of an entity. The Commentary on Article 4(3) of the OECD MTC also does not provide the facts and circumstances that should be considered to determine the POEM of dual resident corporations.

## **1 2 Research Problem and Objectives**

Prior to 2008, the OECD POEM residence tie-breaker test was generally interpreted as the meeting place of a company's board of directors.<sup>28</sup> This interpretation was found to result in multiple locations of effective management for companies. The use of telecommunications by company directors as a means of conducting board meetings caused multiple places of effective management.<sup>29</sup> Thus the interpretation of the POEM as the meeting place of the board of directors was not an efficient dual residence tie-breaker test.

In an effort to counteract the problems caused by the interpretation of the POEM as the meeting place of a company's board of directors, the OECD then made changes to its interpretation of the POEM. The POEM of a company is now located at the place where its 'key management and commercial decisions are made'<sup>30</sup> and 'all relevant facts and circumstances'<sup>31</sup> have to be considered to ascertain this place.<sup>32</sup> The level or type of key management and commercial decisions that should be considered to determine the

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<sup>27</sup> Ibid.

<sup>28</sup> Commentary on Art 4(3) of the OECD Model Tax Convention on Income and on Capital 2003 para24.

<sup>29</sup> OECD 'The Impact of the Communications Revolution on the Application of "Place of Effective Management" as a Tie-breaker: A Discussion Paper From the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits' February 2001 8 available at <http://www.oecd.org/tax/treaties/1923328.pdf> accessed on 4 May 2013.

<sup>30</sup> Commentary on Art 4(3) of the OECD Model Tax Convention on Income and on Capital 2012 para24.

<sup>31</sup> Ibid.

<sup>32</sup> Ibid.

POEM of an entity are not stated in the OECD Commentary on Article 4 (3) of the Tax Convention.<sup>33</sup> The Commentary on Article 4 (3) of the OECD MTC also does not give any guidelines of the facts and circumstances that should be considered to determine the POEM of an entity.

The main research problem is:

- What is the meaning and interpretation of the POEM test in the OECD MTC and in tax treaties, in a corporate world subdued with telecommunications and different modern company management structures?

The lack of a precise and clear interpretation of the POEM test in the OECD Commentary and in tax treaties causes dual tax residence. This subverts the intention of the OECD,<sup>34</sup> which is allocating a single place of residence for dual resident corporations. The OECD's interpretation of the POEM can be easily manipulated by companies, as they can choose to make key management decisions in low- taxing jurisdictions. Ascertaining the interpretation and constituents<sup>35</sup> of the POEM test will help eliminate inconsistencies in the interpretation of the test and avert cases of dual residence for corporations in tax treaties. The research's main objectives are:

- Ascertaining the interpretation of the POEM test in the OECD MTC and in tax treaties.
- Highlighting the effect of Telecommunications on the POEM interpretation stated in the OECD Commentary on Article 4 (3).
- Discussing the interpretive problems of the OECD's POEM interpretation.
- Addressing the challenges that the OECD POEM interpretation faces.
- Proposing a dual residence tie breaker test will not be easily manipulated by companies and which also prevents corporate dual residence in international tax.

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<sup>33</sup> OECD Model Tax Convention on Income and on Capital 2012.

<sup>34</sup> Organization for Economic Cooperation and Development.

<sup>35</sup> key management and commercial decisions and facts and circumstances.

### 1 3 Research Methodology

The practical application of the POEM tie-breaker test and various other residence tests will be examined in light of the twenty-first century company management structures and the use of telecommunications by companies. A thorough investigation of the Commentary on Article 4 (3) of the OECD MTC is also conducted in the research. Although the purpose of the POEM test in domestic tax legislation and in tax treaties is different,<sup>36</sup> the interpretation of the POEM by the SARS will be used as a guide to interpret the POEM concept in the OECD Commentary on Article 4(3) of the Model Tax Convention. The SARS interpretation of the POEM will be used as an interpretational tool because it provides a comprehensive interpretation of the POEM. The views of different authors and case law on this subject will also be examined as a means of interpreting the OECD POEM test. The research also turns to treaty interpretation tools in an effort to interpret the POEM test.

The research analyses various corporate residence tests for their suitability as dual residence tie-breaker test in tax treaties and in the OECD MTC. The shortfalls and the merits of certain corporate residence tests will be highlighted in order to determine the suitability of the tests as corporate residence tie-breaker tests in tax treaties. Establishing a succinct and ascertainable dual residence tie-breaker test will make the process of determining the residence of dual resident companies easier for tax authorities. Taxpayers would also be able to ascertain their tax status without difficulty.

### 1 4 Delimitation of the Research

The research focuses on the residence of companies as legal persons which are liable to tax in tax treaties. Juristic persons such as trusts and partnerships are not necessarily regarded as legal persons in some tax treaties; hence they are excluded from the scope of this research. The *Smallwood*<sup>37</sup> and *Oceanic Trust*<sup>38</sup> cases are excluded from this paper because these cases specifically dealt with the POEM of trusts.

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<sup>36</sup> The place of effective management is used in tax treaties as a tie-breaker clause in cases of dual resident juristic persons and in domestic tax laws it is used to determine the residence of non-individual persons.

<sup>37</sup> *Smallwood and Another V Revenue and Customs Commissioners* (2008) (SCD) 629.

## **1 5 Research Outline**

This research paper has six chapters.

**Chapter 1** introduces the concept of residence in tax treaties and explains how the problem of dual residence arises in tax treaties. The Chapter also outlines the interpretation of the POEM residence tie-breaker test that is used in the OECD MTC and in most tax treaties to allocate dual residence entities a single place of residence. The Research Problem, Objectives, Methodology and the Delimitation of the Research are also outlined in this chapter.

**Chapter 2** highlights the problems associated with the OECD POEM interpretation and tries to interpret the OECD's interpretation of the POEM by using treaty interpretation tools, the SARS Interpretation Note on the POEM and various other guides. Other interpretations of the POEM test are also reviewed and analysed in an effort to find an interpretation of the POEM is in line with the use of telecommunications in companies.

**Chapter 3** poses suggestions of relevant facts and circumstances that can be used to determine the POEM of a dual resident corporation.

**Chapter 4** provides a review and analysis of the TAG's suggestions for changes to the OECD POEM residence tie-breaker test. The TAG's suggestions are also analysed so as to determine whether they would be useful in allocating dual resident companies a single place of residence.

**Chapter 5** gives an overview and an examination of domestic tax residence tests and treaty tie-breaker residence tests in order to determine their suitability and effectiveness as dual residence tie-breaker tests for dual resident companies.

**Chapter 6** provides a conclusion of the research and recommendations.

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<sup>38</sup> *Oceanic Trust Co Ltd N.O V The Commissioner for the South African Revenue Services* 22556/09 (2011).

## Chapter 2

### 2 1 Introduction

This chapter provides an overview of the OECD's definition of resident and addresses the complications associated with the OECD's interpretation of the POEM test. In this chapter treaty interpretation tools, the SARS Interpretation Note on the POEM and the case of *Laerstate BV v The Commissioner for Her Majesty Revenue & Customs*<sup>39</sup> will be used as guides to interpret the OECD POEM dual residence tie- breaker test. Authors' interpretations of the POEM test are also reviewed and analysed in this chapter, so as to find an interpretation of the POEM that is in line with the use telecommunications and modern company management structures.

### 2 2 The OECD's Interpretation of Resident

Article 4 of the OECD MTC considers a resident to be a person who qualifies as a resident under the domestic laws of a country and has a tax liability<sup>40</sup> in a country by virtue of his domicile, place of management or any other norms. A person who only sources income or capital from a country is excluded from the definition of resident in the OECD MTC.<sup>41</sup> Dual resident companies attain their residency status in their place of effective management.<sup>42</sup>

### 2 3 Problems with the OECD Interpretation of the POEM

#### 2 3 1 Effective Management

The phrase 'effective management' has various interpretations; it may refer to certain kinds of management decisions or a particular management level.<sup>43</sup> Effective management can be exercised at any management level. The phrase also seems to be descriptive of a certain type or nature of management.

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<sup>39</sup> (2009) UKFIT 209 TC

<sup>40</sup> In the OECD MTC persons who are liable to tax are; persons which local revenue authorities has the free and unencumbered right to tax

<sup>41</sup> Art 4 (1) of the OECD Model Tax Convention on Income and on Capital 201 pM-13 para1.

<sup>42</sup> Art 4(3) of the OECD Model Tax Convention on Income and on Capital 2012 pM-13 para 3.

<sup>43</sup> B A Van Der Merwe 'Residence of a Company- the Meaning of "Effective Management' ( 2002) 14 SA Merc LJ 81.

Article 3 of the OECD MTC provides definitions of the terms used in the Convention. The phrase ‘effective management’ should also have been explained or defined in Article 4(3) of the OECD MTC for clarity purposes.

### **2 3 2 ‘The Place where Decisions are made’**

The OECD Commentary on Article 4(3) regards the place where ‘key management and commercial decisions’<sup>44</sup> are made as pivotal when determining the POEM of an entity. Company directors and senior company management can choose to make key management decisions in any country in the world; hence making the POEM of a company uncertain. Directors can also constantly shift their place of making key management decisions to low taxing jurisdictions. Thus the POEM test can be used by companies to manipulate taxing systems and to reduce their tax liability.

In a case where a company’s sole director makes key company decisions, in a plane flying over an ocean, the POEM of an entity would not be ascertainable.<sup>45</sup> In such a circumstance treaty contracting states cannot assert the treaty residence of such a company.

Company management can also conduct meetings through telecommunication and this eliminates the need to be physically present in a single location or jurisdiction. If participation in decision making and implementation is conducted via teleconferencing this would dilute the single place of effective management stated in the OECD Commentary on Article 4(3) of the Convention.

### **2 3 3 ‘Key Management and Commercial Decisions’**

In cases of corporate dual residence, the OECD regards the POEM of an entity as its place of residence.<sup>46</sup> The POEM is interpreted as ‘the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a

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<sup>44</sup>Commentary on Art 4 (3) of the OECD Model Tax Convention on Income and on Capital 2012.

<sup>45</sup> OECD ‘The Impact of the Communications Revolution on the Application of the “Place of Effective Management”’: A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits’ 2001 9 available at <http://www.oecd.org/tax/treaties/1923328.pdf> accessed on 3 May 2013

<sup>46</sup> Art 4(3) of the OECD Model Tax Convention on Income and on Capital 2012

whole are in substance made'.<sup>47</sup> The place where key management and commercial decisions of a company are made is important when determining the POEM of a company.<sup>48</sup> The OECD does not describe the kind or type of management decisions that are determinative of the POEM. One wonders whether such decisions are policy management decisions made by a company's board of directors, or daily management and commercial decisions made by managers in the running of a business. Some authors suggest that the 'key management and commercial decisions' referred to in the OECD Commentary describe daily operational management decisions of a whole entity.<sup>49</sup>

The constituents of key management and commercial decisions are not defined or outlined in the OECD Commentary on Article 4(3) of the Model. Contracting states to a treaty can also consider different sets of 'key management and commercial decisions' as determinative of the POEM of a company. If a company satisfies the 'key commercial and management decisions' criterion in two countries, such a company will be considered resident in the two countries. This will result in dual residence. The OECD needs to state the constituents of key management and commercial decisions in a treaty context so as to eliminate corporate dual residence.

### **2 3 4 'Facts and Circumstances'**

According to the OECD Commentary on Article 4(3) of the MTC, to determine the POEM of an entity all the relevant facts and circumstances should be considered.<sup>50</sup> The OECD Commentary on Article 4(3) does not provide guidelines of the facts and circumstances that have to be considered to determine the POEM of a dual resident corporation. One would assume that the facts and circumstances that should be utilised to determine the POEM of an entity should relate to actual or real company management decisions because in the wording structure of the OECD Commentary on Article 4(3); the key management and commercial decisions criterion precedes the facts and circumstances inquiry when determining the POEM of an entity.

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<sup>47</sup>Commentary on Art 4(3) of the OECD Model Tax Convention on Income and on Capital 2012 para 24 .

<sup>48</sup> Van Der Merwe 'The Phrase "place of effective management": Effectively Explained?' (2006) 18 *SA Merc LJ* 123.

<sup>49</sup> Peter Harris & David Olivier *International Commercial Tax* (2010) 66.

<sup>50</sup> Commentary on Art 4 (3) OECD Model Tax Convention on Income and on Capital 2012 para 24.

The absence of the ‘facts and circumstances’ guidelines in the OECD Commentary on the POEM could be attributed to the fact that the OECD allows its members a particular measure of flexibility for the application of the Model Tax Convention.<sup>51</sup> One would also assume that the lack of guidelines for the ‘fact and circumstances’ that have to be considered to determine the POEM of an entity is because of the difficulty in reaching consensus regarding such guidelines among the large number of OECD member countries.

### **2 3 5 Telecommunication and the POEM Interpretation**

Application of the POEM tie-breaker test fails to single out a distinct place of residence for dual resident corporations in the modern business world where video conferencing and various other forms of telecommunication are used to conduct meetings and to make important business management decisions because of the different global locations of directors and senior management. This inevitably leads to multiple locations of effective management because key management and commercial decisions of an entity would be made by directors in different global locations.<sup>52</sup> In such an instance, a company will not have an ascertainable POEM. This raises a need to create a dual residence tie-breaker clause that is in line with modern communication technology and that will allocate a single place of residence for dual resident corporations.

### **2 3 6 Modern Company Management Structures**

The OECD POEM interpretation relates to the structure of traditional companies where management divisions were clearly divided and located in a single country. Nowadays management structures of multinational corporations are spread across different countries. A company’s management can continuously make decisions in its offices located in different countries.<sup>53</sup> In such an instance, modern day company management structures would make the POEM of an entity mobile. Although treaty residence is

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<sup>51</sup> OECD Model Tax Convention on Income and on Capital 2012 p1-8 para 27.

<sup>52</sup> OECD ‘Discussion Paper ‘The Impact of the Communications Revolution on the Place of Effective Management as a Tie-Breaker’ (2001) 8 available at <http://www.oecd.org/tax/treaties/1923328.pdf> accessed on 3 May 2013.

<sup>53</sup> OECD ‘The Impact of the Communications Revolution on the Application of “Place of Effective Management as a Tie-Breaker Rule: A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits’ (2001) 9 available at <http://www.oecd.org/tax/treaties/1923328.pdf> accessed on 6 May 2013.

determined on a day to day basis, the mobility of the POEM can render the residence status of a dual resident multinational corporation uncertain.

Technology and modern company management structures have made the POEM of a company a matter of choice and it can be manipulated by company directors.<sup>54</sup> In the past, the use of telecommunication in company management was minimal, and most traditional companies had one physical location where business and management decisions of a company were made. Key management and commercial decisions would be made in one country and the tax treaty residence of companies would be easily ascertainable. Nowadays, directors or a company's management spread across different countries can use different forms of telecommunication to make key management decisions of a company. In such a situation, it would be difficult to ascertain or locate the POEM of the company. Telecommunications and modern company management structures have made it difficult to locate one permanent POEM for dual resident corporations.<sup>55</sup>

The illustrated ineffectiveness and the lack of precision when interpreting the POEM as a dual residence tie-breaker test raises the need to refine the POEM interpretation and the development of a new tie-breaker clause in tax treaties. The OECD POEM interpretation is susceptible to manipulation because directors can easily change the place where they make important company decisions. Company directors can choose to constantly make key company decisions in low taxing jurisdictions so as to lessen or lower their tax liability.

One would assume that the OECD has not replaced the POEM tie-breaker test or changed its interpretation because it believes that cases of dual residence are rare in

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<sup>54</sup> The board of directors can decide to hold a meeting at an airport in a low taxing jurisdiction or through communication technology whilst they are located in different taxing jurisdictions this dilutes POEM.

<sup>55</sup> B A Van Der Merwe 'The Phrase "place of effective management": Effectively Explained?' (2006) 18 *SA Merc LJ* 127.

international tax.<sup>56</sup> The OECD Commentary on Article 4(3) states that taxing authorities of treaty contracting states may resolve dual residence cases.<sup>57</sup>

## 2 4 Interpretation of Treaties

A treaty should be interpreted in its ‘context and in light of its objects and purpose’.<sup>58</sup> Interpretation of treaties should be done in a manner which is compatible with the terms used in a treaty.<sup>59</sup> The object and purpose of the OECD MTC is to clarify situations of taxpayers and to provide ‘mutual solutions to similar cases of double taxation’.<sup>60</sup> The object and purpose of tax treaties is to prevent double taxation in income tax flows.<sup>61</sup> The POEM dual residence tie-breaker clause has different interpretations even when interpreted with the object of eliminating double taxation. The constituents of the OECD POEM interpretation are too general; the commentary does not specify the kind or type of management decisions that are determinative of the POEM, nor does it give guidelines of the facts and circumstances that have to be considered to determine the POEM of a dual resident entity.

## 2 5 Ordinary meaning of ‘Effective Management’

The meaning of the word ‘effective’ is the essence of the POEM residence tie-breaker clause in the OECD MTC. ‘Effective’ means operative, impressive, actual, producing intended results’.<sup>62</sup> An effective centre is described as the ‘place where the brain of management and control of a company is located’.<sup>63</sup> Management is defined as the ‘process of dealing with or controlling things or people’; collectively defined it is ‘managing a company or organization; the responsibility for and control of a company or organization’.<sup>64</sup>

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<sup>56</sup> OECD Commentary on Art 4(3) of the Model Tax Convention on Income and on Capital 2012 para 24.1.

<sup>57</sup> Ibid.

<sup>58</sup> Art 31 of the Vienna Convention on the Law of Treaties of 1969.

<sup>59</sup> *Commissioner for the South African Revenue Services V Tradehold Ltd* 2013 (4) SA 184 (SCA) para 22.

<sup>60</sup> OECD Model Tax Convention on Income and on Capital 2012 p I-4 para 15.

<sup>61</sup> Jon E Bischel ‘Basic Approaches to Treaty Negotiation’ available at [http://www.un.org/esa/ffd/tax/sixthsession/CRP10\\_Section1.pdf](http://www.un.org/esa/ffd/tax/sixthsession/CRP10_Section1.pdf) accessed on 29 May 2013.

<sup>62</sup> Oxford English Dictionary available at <http://oxforddictionaries.com/definition/english/effective> accessed on 3 May 2013.

<sup>63</sup> Committee of the League of Nations of 1925, Russo & Fontana op cit note 12 at 200.

<sup>64</sup> Oxford English Dictionary available at <http://oxforddictionaries.com/definition/english/management> accessed on 3 May 2013.

The POEM dual residence tie-breaker test could be interpreted as the location of the operative and actual management of a company. The brain of management<sup>65</sup> and control of a company would be its board of directors. Such an interpretation of the POEM would be the same as the repealed OECD interpretation of the POEM.<sup>66</sup> This interpretation would not be a suitable residence tie-breaker clause because company directors may not always make crucial and important company management decisions. In instances where senior management makes operative and crucial company management decisions, real and effective management of the company would lie in the hands of senior company management. In cases where puppet company directors are appointed and they act on key company management decisions made by an outsider, effective management would be considered to be located where such outsider made the management decisions.

Since treaty interpretation tools and dictionaries have not been useful in defining and interpreting the POEM test, guidance will be sought from the SARS interpretation of the POEM test.

## **2 6 Guidance from the SARS Interpretation of POEM**

The purpose of the POEM test in domestic tax legislation is determining the residence of non-individual entities<sup>67</sup> whilst in tax treaties the POEM is used as a tie-breaker test in cases of dual residence of juristic persons. Despite this difference, the SARS POEM interpretation could provide useful guidelines to the unclear ‘facts and circumstances’ criterion stated in the OECD Commentary on Article 4 (3) of the OECD MTC.

### **2 6 1 The SARS Interpretation Note on Effective Management**

The SARS Interpretation Notes are purposefully used as an interpretive guide by the Revenue Authority.<sup>68</sup> The Note interprets the POEM concept and provides guidelines on

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<sup>65</sup> The brain of management of a company is usually the controlling body of a company.

<sup>66</sup> Commentary on Art 4(3) of the OECD Model Tax Convention on Income and on Capital 2003. The place of effective management was generally defined as the meeting place of the board of directors.

<sup>67</sup> Income Tax Act 58 of 1962 S1- definition of resident.

<sup>68</sup> Chris Evans, Judith Freedman & Richard E Krever *The Tax Delicate Balance, Tax Discretion & the Rule of Law* (2011) 188.

the interpretation of the POEM test. It also provides alternative measures of determining residence, should effective management not be located in a single place of residence.<sup>69</sup>

The SARS distinguishes three different levels of management activities;<sup>70</sup>

- Central management and control as implemented/executed by the board of directors; the board makes policy and strategic management decisions.
- Implementation and execution of policy and strategic decisions as carried out by senior management and executive directors. Daily operational and business activities are also conducted by senior management.
- The carrying out or conducting of daily business activities.

The South African Revenue Authority describes the second level of management as the implementation and execution of company policy and strategic decisions. Senior company management is not only concerned with daily company management or implementation of policy decisions. In certain instances, senior company management develops key policy and strategic decisions of a company.<sup>71</sup> The SARS description of the second level of company management might not be indicative of all the responsibilities and undertakings of senior company management.

The general approach adopted by the SARS is that the POEM is the place where daily company management is conducted by directors or senior managers regardless of the authoritative control exercised in board meetings by directors.<sup>72</sup> Management by these senior managers is considered to be implementation and execution of policy and strategic decisions made by the board of directors.<sup>73</sup> If such management takes place in a single place, that location will be the POEM of an entity.<sup>74</sup>

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<sup>69</sup>Van Der Merwe op cit note 55 at 127.

<sup>70</sup> SARS Interpretation Note: Place of Effective Management 6 of 2002 para 3.1.

<sup>71</sup> SARS Legal and Policy Department South African Revenue Service: Discussion Paper on Interpretation Note 6 – Place of Effective Management para 12 available at <http://www.sars.gov.za/AllDocs/LegalDoelib/DiscPapers/LAPD-LPrep-DP-2011-02%20-%20Discussion%20Paper%20POEM%20on%20IN6.pdf> accessed on 13 July 2013.

<sup>72</sup> SARS Interpretation Note : Place of Effective Management 6 of 2002 para 3.2.

<sup>73</sup> Ibid

<sup>74</sup> SARS Interpretation Note: Place of Effective Management 6 of 2002 para 3.3.

The SARS Interpretation Note does not state whether implementation of decisions is signing of documents or putting into practice management decisions.<sup>75</sup> One would assume that the Revenue Authority meant the latter because it favours daily operational management as the POEM of an entity. In situations where a management act consists of several separate actions implemented in various countries, the POEM of an entity would not be ascertainable. Making the place of implementation of decisions decisive of the POEM would not single out one residence location for a dual resident company. The interpretation of the POEM as the place where implementation of company decisions takes place would only be a suitable residence tie-breaker test, if company decisions are implemented in one country/jurisdiction, and if a company's documentation reflects the place of implementation of such decisions.<sup>76</sup> This would be a useful guide for locating the POEM of a dual resident company for treaty purposes.

The interpretation of the POEM as daily management of a business might not necessarily reflect the actual place where a company is controlled.<sup>77</sup> The place where a company is actually controlled is not necessarily the same place where daily management of a company takes place.<sup>78</sup> Daily activities of a business usually take place where a company carries on business whereas the board of directors can control the company anywhere.<sup>79</sup> The exercise of authoritative management and control of a company by senior management or directors would perhaps be a better indicator of the POEM of an entity than the place where daily management occurs.

The South African Revenue Services, Legal and Policy Department recommended that the type of senior management that is indicative of effective management should be limited to 'top personnel who call the shots and exercise realistic positive management'<sup>80</sup> of a company. The Department also recommended that daily management of a company should not be determinate of the POEM of an entity.

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<sup>75</sup> Implementation is defined as the process of putting a decision or plan into effect; execution.

<sup>76</sup> Olivier & Honiball op cit note 6 at 27.

<sup>77</sup> Van Der Merwe op cite note 43 at 82.

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> SARS Legal and Policy Department South African Revenue Service : Discussion Paper on Interpretation Note 6-Place of Effective Management September 2011 para 8.1 available at

The SARS suggests that if an entity's management functions are implemented from different locations because of the use of telecommunication, the POEM of an entity will be identified in the place where its commercial operations or activities are actually conducted.<sup>81</sup> This interpretation will not necessarily result in a single place of residence for dual resident companies, in cases where a company's business activities are conducted in different countries/locations.<sup>82</sup>

The SARS Interpretation Note states that if the business activities of an entity are conducted from various locations, the place where an entity has the strongest economic nexus will be the POEM of the entity.<sup>83</sup> This rule is not specifically connected with effective management but rather seems to be an optional method to determine residence.<sup>84</sup> The economic nexus rule does not have guidelines and is not explained in the SARS Interpretation Note. It is assumed that the rule might have its origin in the theory of economic allegiance,<sup>85</sup> which has a strong link with source based taxation.<sup>86</sup> It has also been argued that the economic nexus criterion has strong links with residence as a jurisdictional determinant; because a person is considered to be a resident of a country if the person has close economic and personal ties to the country.<sup>87</sup>

A residence treaty tie-breaker test based on the economic nexus criterion would result in entities that derive their profits and financial infrastructure from a state being regarded as residents of that state. This would not reveal the place where a company is actually controlled, because business finance can be attained in a different place from the place where a company is controlled. The economic nexus criterion could also blur the differentiation between taxing rights of source and residence jurisdictions.<sup>88</sup>

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<http://www.sars.gov.za/AllDocs/LegalDoclib/DiscPapers/LAPD-LPrep-DP-2011-02%20-%20Discussion%20Paper%20POEM%20on%20IN6.pdf> accessed on 7 May 2013.

<sup>81</sup> SARS Interpretation Note: Place of Effective Management 6 of 2002 para 3.3.

<sup>82</sup> Van Der Merwe op cit note 55 at 128.

<sup>83</sup> SARS Interpretation Note: Place of Effective Management 6 of 2002 para 3.3.

<sup>84</sup> Van Der Merwe op cit note 55 at 128.

<sup>85</sup> OECD 'The Impact of the Communications Revolution on the Application of the "Place of Effective Management" As a Tie-Breaker' (2001) 12 available at <http://www.oecd.org/tax/treaties/1923328.pdf> accessed on 29 May 2013.

<sup>86</sup> Source based taxation asserts taxing rights on the basis of country's entitlement to share in the wealth from income generated from economic activity within that country, Meyerowitz Meyerowitz *on Income Tax* (2005) para 7.1.

<sup>87</sup> Victor Thuronyi (ed) *Tax Law Design and Drafting* (1998) 729.

<sup>88</sup> Van Der Merwe op cit note 55 at 130.

## 2 6 2 Facts and Circumstances

The SARS Interpretation Note on the POEM outlines relevant facts and circumstances which have to be considered to determine the POEM of an entity. The Notes outlines the following facts and circumstances:<sup>89</sup>

- ‘The place where the centre of top level management is located’.<sup>90</sup>
- The ‘location and functions performed at [a company’s] headquarters’.<sup>91</sup>
- The place ‘where [an entity’s] business operations are actually conducted’.<sup>92</sup>
- The place ‘where controlling shareholders make key management and commercial decisions of the company’.<sup>93</sup>
- ‘Legal Factors such as the place of incorporation, formation or establishment, the location of the registered office and public office’.<sup>94</sup>
- The place ‘where the directors or senior managers or the designated manager who are responsible for the day- to -day management reside’.<sup>95</sup>
- ‘The frequency of the meetings of the entity’s directors or senior managers and where they take place ;
- The experience and skills of the directors , managers , trustees or designated managers who purport to manage the entity;
- The actual activities and physical location of senior employees ;
- The scale of onshore as opposed to offshore operations;
- The nature of powers conferred upon representatives of the entity, the manner in which those powers are exercised by the representatives and the purpose of conferring the powers to the representatives’.<sup>96</sup>

There are some inconsistencies between some of the facts and circumstances highlighted in the SARS Interpretation Note on the POEM.<sup>97</sup> The place where shareholders make

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<sup>89</sup>SARS Interpretation Note: Place of Effective Management 6 of 2002 para 3.3.

<sup>90</sup>Ibid

<sup>91</sup>Ibid

<sup>92</sup>Ibid

<sup>93</sup>Ibid

<sup>94</sup>Ibid

<sup>95</sup>Ibid

<sup>96</sup>Ibid

key company decisions seems to be an internal company determinant of the POEM of an entity and the place of incorporation of a company is an external or formal determinant of the POEM. The inconsistencies outlined in the Interpretation Note's facts and circumstances criterion might not reveal the real place of a company's management.

The inclusion of the residence of directors in the facts and circumstances criterion is probably based on the argument that they reside close to the place where daily company operations take place and where the company's essential decisions are executed.<sup>98</sup> In cases where a company does not require physical presence of its directors to conduct business or where management allows directors and managers to work in remote locations, the place of residence of a manager or a director would not be a useful determinant of a company's POEM.

The Interpretation Note deals with the issue of 'effective management' on a facts and circumstances approach, based on the business of a company. The flexibility of the facts and circumstances approach may provide an incentive for entities to shift their residence by moving the POEM of a company to a tax haven,<sup>99</sup> and this does not counteract the problem of tax avoidance in international tax law. The ability to avoid creating a single location of 'effective management' is also exacerbated by the use of telecommunication in companies. Management and implementation of company decisions can be done by senior management in different countries through communication technology. In such instances, the POEM of an entity would not be identifiable.

The OECD's interpretation of the POEM is anchored on the making of decisions by a company. This differs with the interpretation of the POEM in the SARS Interpretation Note which considers the place of implementation of decisions by senior staff and executives as the POEM of an entity. A test for 'effective management' based on the place where 'key management decisions' are made is much easier to manipulate than the SARS interpretation of effective management which considers the place where

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<sup>97</sup>SARS Legal and Policy Department South African Revenue Service: Discussion Paper on Interpretation Note 6 Place of Effective Management September 2011 para 6 available at <http://www.sars.gov.za/AllDocs/LegalDoclib/DiscPapers/LAPD-LPrep-DP-2011-02%20-%20Discussion%20Paper%20POEM%20on%20IN6.pdf> accessed on 8 June 2013.

<sup>98</sup> Van Der Merwe op cit note 55 at 133.

<sup>99</sup> Van Der Merwe op cit note 55 at 134.

company management is carried on by senior executives. The SARS interpretation of the POEM is much more informative as it highlights the facts and circumstances that have to be considered to determine the POEM of an entity.

Even though the SARS interpretation of the POEM tries to keep pace with the perceivable changes in management structures and telecommunication, such interpretation is still susceptible to manipulation. The interpretation of the POEM as the place where daily management of a company takes place may result in multiple residence locations for an entity; because daily management of multi-national companies can take place in various countries.

The South African constitution requires courts to consistently interpret legislation in line with international law interpretations, and courts should not interpret legislation contrary to international law interpretations.<sup>100</sup> This negates the value and effectiveness of the SARS Interpretation Note on Effective Management as it has no force in South African law, though the SARS is bound by its Interpretation Notes.<sup>101</sup> The OECD Commentaries are highly persuasive because they are part of a legal context of a treaty.<sup>102</sup> South African Courts seem to follow the OECD interpretation of the POEM as evidenced in the *Commissioner for the South African Revenue Services V Tradehold Ltd*<sup>103</sup> case where the court made a remark that the POEM of a company is the meeting place of its board of directors.

Although the SARS Interpretation Note on Effective Management is of no force in South African Law, the facts and circumstances guideline in the SARS Interpretation Note can be a useful guideline of the ‘facts and circumstances’ criterion used to determine the POEM in the OECD Commentary on Article 4(3).

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<sup>100</sup> Constitution of the Republic of South Africa of 1996 s233

<sup>101</sup> <http://www.sars.gov.za/Legal/Interpretation-Rulings/Pages/default.aspx>

<sup>102</sup> D A Ward ‘Access to Tax Treaty Benefits –Research Report Prepared for the Advisory Panel on Canada’s System of International Tax’ 2008 p14 available at <http://www.apcsit-gcrcfi.ca/06/rr-re/rr12%20-%20ward%20-%20en%20-%20final%20-%20090618.pdf> accessed on 10 May2013 ,*Crown Forest Industries Ltd V Canada* 1995( 2) 802 (S.C.R).

<sup>103</sup> *Commissioner for the South African Revenue Services V Tradehold Ltd* 2013 (4) 184 (SCA)

## **2 7 Guidance from *Laerstate BV v The Commissioners for Her Majesty Revenue and Customs* (2009) UKFTT 209 TC**

The *Laerstate case* dealt with the issue of the central management and control of a company and the POEM of a dual resident company. The major question in the case was whether Laerstate BV, a company incorporated in the Netherlands, was a UK resident by reason of its sole shareholder<sup>104</sup> making substantial policy and strategic management decisions in the UK.<sup>105</sup> The court first examined if Laerstate BV was centrally managed and controlled in the UK in accordance with the UK domestic tax laws. Laerstate's memorandum of association stated that its directors were responsible for the management of the company and were independently authorised to represent the company.<sup>106</sup>

The place of CM &C of a company is generally interpreted to be the location of the real or actual management of a company.<sup>107</sup> The UK Revenue Authority<sup>108</sup> highlighted that the place of CM &C of a company is likely to be the place where its board of directors meet.<sup>109</sup> The UK Revenue also stated that determining the place of CM&C of a company is a question of fact which involves a 'scrutiny of the course of business and trading',<sup>110</sup> of an entity. The case gave important corporate considerations that have to be taken into account, to determine the place of CM &C of a company. These guidelines would be useful aids/ factors to determine the POEM of a dual resident company. In the determination of the place of central management and control of the company, the Court made the following important assertions:

- The mere act of ratifying resolutions or documents does not constitute real management.<sup>111</sup>

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<sup>104</sup> *Laerstate BV v The Commissioner for Her Majesty Revenue and Customs* [2009] UKFTT 209 (TC) at p32.

<sup>105</sup> *Ibid* at p24.

<sup>106</sup> *Ibid* at p7.

<sup>107</sup> *De Beers Consolidated Mines Limited v Howe* [1906] AC 455 para 458.

<sup>108</sup> Her Majesty Revenue and Customs

<sup>109</sup> *Laerstate* supra note 104 .

<sup>110</sup> *Ibid* at p34.

<sup>111</sup> *Ibid* at p35.

- The decisions made by company management should be effective and informed decisions; management should have the absolute minimum information to make commercial decisions.<sup>112</sup>
- Reckless or uninformed company management decisions are still regarded as management decisions.<sup>113</sup>
- In cases where a director is instructed by another director to sign company documents without considering the intent of signing such documents, the instructing director would be considered the core of real company management.<sup>114</sup>

The Appeal Court held that Mr Bock, the sole shareholder of Laerstate had sufficient information to make informed company management decisions independently.<sup>115</sup> The place of CM &C of Laerstate BV was found to be in the UK because decisions on policy and strategic management of Laerstate BV were made in the UK by the company's sole shareholder Mr Bock. Laerstate was found to be a UK resident company.

The court also considered the place where Laerstate was effectively managed because it was a dual resident in terms of the DTA between the Netherlands and the United Kingdom. The Court interpreted the POEM residence tie-breaker test as the location of the 'real top level management/ realistic positive management'<sup>116</sup> of an entity. The court found that Laerstate's sole shareholder made policy and strategic management decisions in the UK<sup>117</sup> and held that Laerstate was effectively managed in the UK.<sup>118</sup>

In instances where a company's board of directors implements or signs decisions made by shareholders, the place where the shareholder made company decisions would be the POEM of an entity. Therefore, as highlighted in the *Laerstate*<sup>119</sup> case, the POEM

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<sup>112</sup>Ibid.

<sup>113</sup>Ibid at p36.

<sup>114</sup>Ibid at p40.

<sup>115</sup>Ibid at p38.

<sup>116</sup>Ibid at p42.

<sup>117</sup>Ibid.

<sup>118</sup>Ibid

<sup>119</sup>Ibid.

of an entity lies with the person or group of persons who make significant policy and strategic decisions of a company.

## **2 8 Authors' Interpretations of the POEM**

Van Blerk and Horak point out that the POEM is where the daily running of a business takes place, while, the place from which a business is controlled is where its board of directors normally meet.<sup>120</sup> The two places will not necessary coincide.<sup>121</sup> The interpretation of the POEM as the place where daily company management takes place should not be confined to the place where strategic and policy decisions are made.<sup>122</sup> Vogel contends that the POEM is the place where superior daily management of a business takes place; he states that the 'running of a business is not limited to implementation of decisions, strategic policy making and administration but includes a broad spectrum of decision making steps necessary for the functioning of the business'.<sup>123</sup> The interpretation of the POEM as the place where daily management of a business takes place is problematic in cases where daily company management is spread across different taxing jurisdictions; it would be difficult to locate a single POEM.

Meyerowitz differs with Van Blerk and Horak's view; he believes that the POEM of a company is the place where a company's board meetings take place,<sup>124</sup> and if a company only has executive directors, the place where the executive directors conduct the company's affairs will be the POEM of the company.<sup>125</sup> Olivier highlights that the POEM test refers to the place where the most important and significant management activities take place. The place 'where the shots are called'.<sup>126</sup> This place seems to be the meeting place of a company's board of directors. This interpretation of the POEM can be diluted by the use of telecommunication when a company's board meetings are conducted online or via Skype by company directors in different global locations. In such circumstances, it will be difficult to pinpoint the place where a company is effectively managed.

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<sup>120</sup> Oliver & Honiball op cit note 6 at 28.

<sup>121</sup> Ibid.

<sup>122</sup> Lynette Olivier 'Residence Based Taxation' (2001) *SALJ* 25.

<sup>123</sup> Olivier & Honiball op cit note 6 at 28.

<sup>124</sup> Meyerowitz *Meyerowitz on Income Tax* 2003-2004 para 5.19.

<sup>125</sup> Ibid.

<sup>126</sup> Olivier & Honiball op cit note 6 at 29.

The case of *Commissioner for the South African Revenue Service V Tradehold Ltd*,<sup>127</sup> dealt with the issue of dual residence. The main dispute in the case was the allocation of taxing rights between South Africa and Luxembourg over a deemed disposal of capital assets by Tradehold Limited,<sup>128</sup> a company incorporated in South Africa but effectively managed in Luxembourg in terms of the DTA between South Africa and Luxembourg.<sup>129</sup> The deemed disposal of capital assets arose as a consequence of the relocation of the POEM of Tradehold Ltd from South Africa to Luxembourg.<sup>130</sup> The parties in this case appeared to be in agreement that the POEM of a company is the place where the board meetings of a company take place. Tradehold was held to be resident and taxable in Luxembourg by reason of conducting its board meetings in Luxembourg.<sup>131</sup> The interpretation of the POEM test as the meeting place of a company's board of directors can be easily manipulated by companies, as they can decide to hold board meetings in various low taxing countries, hence making the POEM mobile and not easily ascertainable.

Schwarz interprets the POEM of a company, as the location of the main directing source of a company; the place where one would find the managing director, the company records and senior management staff of a company.<sup>132</sup> The UK Revenue's<sup>133</sup> view is that the POEM and the place of CM &C of an entity will usually be located in the same place.<sup>134</sup> The UK Revenue is also of the view that effective management may be situated at a 'company's true centre of operations'.<sup>135</sup> The true centre of a company's operations will usually be the place where its daily company management takes place rather than the place where directors hold their board meetings. In a case where a multinational company is a dual resident, the interpretation of POEM as the place where

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<sup>127</sup> 2013 (4) SA 184(SCA).

<sup>128</sup> *Tradehold* supra note 59 para 8-27

<sup>129</sup> *Ibid* para 1-3

<sup>130</sup> *Ibid* para 4-8, By reason of changing its place of effective management to Luxembourg, Tradehold ceased to be a South African Resident and was deemed to have disposed of its assets in terms of par 12 of the Eighth Schedule of the Income Tax Act 58 of 1962.

<sup>131</sup> *Tradehold* supra note 59 para 26

<sup>132</sup> Schwarz op cit note 122.

<sup>133</sup> The Commissioners for Her Majesty Revenue and Customs

<sup>134</sup> The UK Revenue (Her Majesty Revenue and Customs) International Tax Manual INTM120070 available at <http://www.hmrc.gov.uk/manuals/intmanual/intm120070.htm> accessed on 8 April 2013.

<sup>135</sup> *Ibid*.

daily company management takes place, would not effectively perform the function of a dual residence tie-breaker test; because daily company management in multinational companies takes place in different countries.

Gutuza contends that there is a *de facto* and legal place of effective management.<sup>136</sup> The *de facto* POEM is located where the mind that effectively manages an entity resides<sup>137</sup> and the legal POEM is found in the company's founding and relevant documents.<sup>138</sup> The POEM of a company consequentially lies with the person who has the controlling powers of a company. In cases where a shareholder instructs the board of directors and they sign documents mindlessly or with less than the required information, the POEM will be located where the shareholder is located.<sup>139</sup> In cases where shareholders of a controlled foreign company operate as the mind and decision maker of the company, the place where such shareholders make company decisions would be indicative of the POEM of a controlled foreign company.

The POEM residence tie-breaker clause requires an examination of the facts and circumstances of each case to establish the actual place where key management decisions are made by a company. If the POEM test were to refer to the meeting place of the board of directors or the place where daily company management is conducted, these places would not always reflect the actual location where a company makes its decisions and would result in multiple places of effective management.<sup>140</sup> Westin suggests that the POEM of a company is the location of the central mind and management of a company.<sup>141</sup> This central mind should have authority to make actual and authoritative company policy and management decisions.

Davis contends that the place where the most vital management decision making and implementation occur is determinative of POEM of a company.<sup>142</sup> Management

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<sup>136</sup>Tracy Gutuza 'Has Recent United Kingdom Case Law Affected the Interplay between "Place of Effective Management" and Controlled Foreign Companies' (2012) 24 *SA Merc LJ* 428.

<sup>137</sup>*Ibid.*

<sup>138</sup>*Ibid.*

<sup>139</sup>*Ibid* at 432.

<sup>140</sup>Section 9C and 9D Revisited (1998) 47 *The Taxpayer Journal* 84.

<sup>141</sup> Richard Westin op cit note 11 at 559.

<sup>142</sup> Van Der Merwe op cit note 43 at 82

includes both making and implementing decisions.<sup>143</sup> In cases where company decisions are made and implemented in different locations this interpretation of the POEM might not single out a distinct place of residence for dual resident corporations in cases where company decisions are made and implemented in different locations.

Van Der Merwe states that if effective management is considered to be daily management of a company, the POEM should be the place where decisions are made and implemented, and if effective management is considered to be the place where superior management meet to make key decisions of a company, the place where decisions are made will be determinative of the POEM of a company.<sup>144</sup>

Some authors suggest that the POEM should be interpreted as the place where a company's board meetings takes place and others contend that the correct interpretation of the POEM test is the place where daily management of an entity takes place.<sup>145</sup> The preferable description of the POEM is the location of the central mind and management of a company.<sup>146</sup> This approach is objective as the central mind and management of a company can be in the hands of a shareholder, company director, or senior manager. This approach warrants a consideration of facts to establish the person who holds and exercises actual and real control of a company.

## **2 9 INTERPRETATION OF THE POEM BY OECD MEMBER STATES**

France interprets the POEM test on a case by case basis, and it interprets the POEM as the meeting place of a company's board of directors<sup>147</sup> and the 'place where the organs of direction, management and control of an entity are located'.<sup>148</sup> France believes that the POEM of an entity will generally correspond with the place where senior executives make the decisions of an entity.<sup>149</sup>

In New Zealand, effective management is interpreted as daily company management regardless of the place where a company is controlled.<sup>150</sup> Italy regards the

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<sup>143</sup> Ibid at 85.

<sup>144</sup> Ibid.

<sup>145</sup> Ibid at 83.

<sup>146</sup> Westin op cit note 11 at 559.

<sup>147</sup> Avi Yonah et al op cit note 10 at 135.

<sup>148</sup> OECD Model Tax Convention on Income and on Capital 2012 para 26.3.

<sup>149</sup> Ibid.

<sup>150</sup> Van Der Merwe op cit note 43 at 84.

POEM of an entity as the place where managerial decisions are made and it usually corresponds with the place where board meetings are held.<sup>151</sup> Hungary states that, the place where important company decisions are made and the place where high level daily management of an entity takes place should be considered when determining the POEM of an entity.<sup>152</sup>

## **2 10 The Effect of Company Law on the Determination of the POEM**

In cases where a company asserts its POEM as the meeting place of the board of directors, the board members must have actual authority and adequate engagement in the business of the company.<sup>153</sup> The directors should be knowledgeable about their company's trade and transactions, and should be able to make authoritative and important company decisions.<sup>154</sup>

The concept of 'effective management' is factual, since delegation of management power to lower management levels of a company is possible.<sup>155</sup> In cases where decision making is delegated to lower company management, the interpretation of the POEM as the meeting place of the board of directors would not reveal the person or body persons who actually manage and control a company.

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<sup>151</sup> Avi Yonah et al op cit note 10 at 136.

<sup>152</sup> OECD Model Tax Convention on Capital and on Income 2012 para 26.4.

<sup>153</sup> Olivier & Honiball op cit note 6 at 26.

<sup>154</sup> Ibid.

<sup>155</sup> Richard L Doernberg & Luc Hinnekens *Electronic Commerce and International Taxation* (1999) 14, *Calcutta Jute Mills V Nicholson* 1876 ITC 83.

## Chapter 3

### 3 1 Relevant Facts and Circumstances when determining the POEM (Suggestions)

This chapter poses possible facts and circumstances that can be used to determine the POEM of a company. The following are suggestions of the facts and circumstances that should be taken into account to determine the POEM of a dual resident company;

- The Companies Act, Company rules and the directing mind of a company.<sup>156</sup>  
Company rules will usually determine the persons who have actual control of a company. In cases where decision making powers are delegated to lower management, such management will effectively manage a company. In cases where company rules are not written or recorded in a company's documents, the Companies Act can be a useful guide to determine the actual management of a company. The Companies Act provides rules of organisation and management of a company<sup>157</sup> and also sets the regulatory environment for companies.<sup>158</sup>
- The nature of the business of a company and the place where company decisions are in substance actually made.<sup>159</sup>
- In cases where dual corporate residence arises as a result of an entity's concurrent residence throughout a tax year, examination the entity's acts of management throughout that year may be appropriate to determine the POEM of a company.<sup>160</sup>
- The 'location of the administrative headquarters and the location of the firm's centre of gravity'.<sup>161</sup>
- When determining the POEM of subsidiary companies ; the independence of the directors in conducting the business of the subsidiary and the extent of their

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<sup>157</sup> Companies Act 71 of 2008.

<sup>158</sup> Companies Act 71 of 2008 s7.

<sup>159</sup> Inland Revenue Tax Bulletin Issue 14 International Taxation of Companies available at [www.inlandrevenue.gov.uk/bulletins/tb14htm#](http://www.inlandrevenue.gov.uk/bulletins/tb14htm#) accessed on 3 June 2013

<sup>160</sup> Schwarz op cit note 9 at 126.

<sup>161</sup> Avi Yonah et al op cit note 10 at 130.

authority in ‘making investment, production, marketing and procurement decisions’,<sup>162</sup> should be taken into account.<sup>163</sup>

- In cases where controlling shareholders make important decisions of a company, the place where the controlling shareholders make decisions would be the POEM of an entity.<sup>164</sup>

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<sup>162</sup> Olivier & Honiball op cit 6 at 40.

<sup>163</sup> Ibid.

<sup>164</sup> *Laerstate* supra note 104 at p 41

## Chapter 4

### 4 1 Introduction

A review and analysis of the suggestions for changes to the OECD POEM dual residence tie-breaker test made by the TAG will be conducted in this chapter, so as to determine if such suggestions would be useful in allocating a corporate dual resident a single place of residence.

### 4 2 Overview of the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (TAG)

The TAG was set up by the OECD Fiscal Affairs in January 1999.<sup>165</sup> TAG is responsible for the examination of treaty rules for the taxation of corporate/business profits in the context of electronic commerce and it also examines suggestions for substitute or unconventional rules.<sup>166</sup>

### 4 3 Suggestions for Changes to the OECD MTC: Place of Effective Management 2003

#### 4 3 1 Refinement of the Place of Effective Management Interpretation

The TAG proposed that where a board of directors makes key management and commercial decisions of a company and officially concludes these decisions in different countries the POEM of the entity should be located where key decisions of the entity are in substance made.<sup>167</sup> It suggested that in situations where a controlling interest holder effectively makes key decisions above normal management and policy formulations of an entity, the POEM of such an entity will be located where the controlling interest holder makes decisions.<sup>168</sup> A controlling interest holder in a company can be determinative of the POEM of a company; in such circumstances treaty residence of a

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<sup>165</sup> OECD 'Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce: Final Report' 2001 p1 available at <http://www.oecd.org/tax/treaties/35869032.pdf> accessed on 5 June 2013.

<sup>166</sup> OECD *Taxation and Electronic Commerce Implementing the Ottawa Taxation Framework Conditions* (2001) 211.

<sup>167</sup> OECD 'Discussion Draft: Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention' 2003 p2 available at <http://www.oecd.org/tax/treaties/2956428.pdf> accessed on 4 May 2013.

<sup>168</sup> Ibid.

CFC<sup>169</sup> can be located in the place where the controlling interest holder is located. This proposal is an objective and commendable way of determining the POEM of an entity. It should be one of the facts that should be considered to determine the POEM of a dual resident company in tax treaties. The proposal takes into consideration the fact that company documentation might not always reveal the person who exercises actual company management and control.

The TAG also suggested that where approval of relevant company decisions takes place in a different jurisdiction from where the decisions of an entity are made, the place where decisions are made is regarded as the POEM of the entity.<sup>170</sup> It should be noted that the place where decisions are made is different from the place where decisions are approved or developed.<sup>171</sup> The interpretation of the POEM as the place where decisions are made would not be able to single out one place of residence for dual resident companies in cases where management decisions are made via telecommunication by directors located in different countries.

In cases where executive officers make commercial and strategic decisions of an entity and the board of directors only approves such decisions, the TAG suggests that the place where the officers perform their tasks should be given weight when locating the POEM of such an entity.<sup>172</sup> When differentiating the place where decisions are made and where they are approved, the place where advice was given on recommendations and the place where decisions were ultimately developed must be given consideration.<sup>173</sup> Effective management will not be located in the place where a group of persons merely signs / approves decisions or where company decisions do not go beyond normal management and policy formulation.<sup>174</sup>

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<sup>169</sup> Controlled Foreign Company : is a company with a foreign shareholder or where foreign shareholders jointly hold more than 50% of the participation rights in a foreign company accessed.

<sup>170</sup> Van Der Merwe op cit note 55 at 124.

<sup>171</sup> Ibid.

<sup>172</sup> OECD 'Discussion Draft; Place of Effective Management Concept : Suggestions for Changes to the OECD Model Tax Convention' 2003 p3 available at <http://www.oecd.org/tax/treaties/2956428.pdf> accessed on 4 May 2013.

<sup>173</sup> Ibid.

<sup>174</sup> Van Der Merwe op cit note 55 at 124.

The OECD contended that the expansive explanation or refinement of the POEM test would not be favoured by the majority of OECD member countries.<sup>175</sup> It gave reason that the TAG's refinement of the POEM test was more aligned with the interpretation of the POEM as the meeting place of the board of directors,<sup>176</sup> this interpretation resulted in multiple places of effective management for companies. For this reason the OECD did not incorporate the refinement of the POEM suggested by the TAG in the OECD Commentary on Article 4(3) of the Model Tax Convention.<sup>177</sup>

#### **4 3 2 Hierarchy of Tests**

The TAG also proposed the following hierarchy of tests to be utilised if the POEM of an entity cannot be determined;<sup>178</sup>

- First, the POEM should be determinative of the place of residence of a dual resident entity.
- Secondly, if the POEM of an entity cannot be situated in any state, it should be considered to be resident in the State where it has its closest economic relations; or in the place where its commercial activities are mainly conducted; or in the place where its senior executive decisions are mainly taken.
- Thirdly, if the second option fails to determine the POEM of an entity, the entity shall be resident in the place of its incorporation;
- Fourthly, if the place of incorporation of an entity is unascertainable, competent authorities of Contracting States should resolve the residency of a dual resident entity by mutual agreement.<sup>179</sup>

According to TAG's hierarchy of tests the economic nexus test is used to determine the residence of a company, if the POEM of an entity cannot be established. This test is based on the finding that an entity should be resident in the state in which it makes

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<sup>175</sup> South African Revenue Authority Discussion Paper on Interpretation Note 6 – Place of Effective Management September 2011 at p9 available at <http://www.sars.gov.za/AllDocs/LegalDoclib/DiscPapers/LAPD-LPrep-DP-2011-02%20-%20Discussion%20Paper%20POEM%20on%20IN6.pdf> accessed on 7 May 2013.

<sup>176</sup> Ibid.

<sup>177</sup> Ibid.

<sup>178</sup> OECD 'Discussion Draft: Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention' 2003 p3 available at <http://www.oecd.org/tax/treaties/2956428.pdf> on 4 May 2013.

<sup>179</sup> Ibid.

substantial use of ‘economic resources, legal, financial and social structures’.<sup>180</sup> When applying this test factors such as employees, company assets, the place where a company’s most business activities are carried out, the headquarters of a company, the place where senior management functions are carried on and the place where an entity has the most economic relations should be considered to determine the place of residence of a dual a resident entity.<sup>181</sup> The practical application of the economic nexus criterion would not be easy, because so many factors have to be considered to find the place where an entity’s economic relations are closest. The test seems to have a greater link with source based taxation than with residence based taxation.<sup>182</sup>

The TAG proposes that if the use of communication technology makes it difficult to identify the POEM of an entity, the place where the entity’s primary business activities are carried on should be used as a yard stick to determine the residence of dual resident entities.<sup>183</sup> A functional analysis of a corporation’s activities must be performed to determine the place where its primary business activities are carried on.<sup>184</sup> The place where the business activities of an entity are mainly conducted might not be determinative of the brain of management and control of an entity. The vital functions of a business can be conducted in a place absent of company management. The main business activities of a company can be located in different global jurisdictions, in such cases this test will not be able to single out one place of residence for a dual resident company. This criterion might not be useful as a dual residence tie-breaker test when dual residence occurs in a treaty.

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<sup>180</sup> Ibid at p5.

<sup>181</sup> Ibid.

<sup>182</sup> OECD ‘The Impact of the Communications Revolution on the “Place of Effective Management” As a Tie Breaker Rule: Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms For The Taxation of Business Profits’ 2001 p12 available at <http://www.oecd.org/tax/treaties/1923328.pdf> accessed on 4 May 2013.

<sup>183</sup> Ibid.

<sup>184</sup> OECD ‘Discussion Draft : Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention’ 2003 p5 available at <http://www.oecd.org/tax/treaties/2956428.pdf> accessed on 4 May 2013

The TAG also suggested that the place where senior executive decisions<sup>185</sup> are taken can be determinative of the place of residence of a dual resident corporation. The place where senior executive decisions are taken is usually at a company's headquarters. The control of a subsidiary company is sometimes located at the headquarters of that company, but this might not be always the case. It is doubtful that this criterion will be useful in allocating a dual resident corporation a single place of residence in cases where executive decisions are taken in different countries.

The place where an entity derives its legal status is normally the place of its incorporation.<sup>186</sup> The POI test is susceptible to manipulation because taxpayers can incorporate a company anywhere in the world. Though this test might be an easier way to allocate a dual resident company a single place of residence, taxpayers can shift and change a company's incorporation status at any time.

If the country in which an entity derives its legal status cannot be determined because of legal uncertainty, the mutual agreement procedure should be utilised to determine the residency of a dual resident entity.<sup>187</sup> Competent authorities of contracting states would have to reach a decision of the place of residence of a dual resident entity. It might take a long time for taxing authorities to reach a residency decision of a corporation and this would be to the detriment of the taxpayer.

The hierarchy of tests proposed by the TAG would be a good substitute of the POEM residence tie-breaker test in the OECD MTC and in tax treaties. The hierarchy of tests is extensive and tries to provide a solution for most corporate dual residence cases. The proposed hierarchy of tests might successfully single out one place of residence for dual resident companies but some of the proposed tests might not indicate or reflect the real place where a company is controlled.

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<sup>185</sup> Executive Company decisions are usually made by a company's President, Vice President or Treasurer

<sup>186</sup> OECD 'Discussion Draft: Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention' 2003 p6 available at <http://www.oecd.org/tax/treaties/2956428.pdf> accessed on 5 May 2013

<sup>187</sup> Ibid.

## Chapter 5

### 5 1 Residence Tests

For purposes of discovering a suitable and effective residence tie-breaker test for dual resident companies, domestic tax residence tests and treaty tie breaker residence tests will be examined in this chapter.

### 5 2 Incorporation Test

The United States Model Income Tax Convention<sup>188</sup> uses the incorporation test to determine the tax residency of companies for treaty purposes.<sup>189</sup> The residence of a company under this test is the place of incorporation of a company.<sup>190</sup> The policy rationale for the POI test is that a corporation owes some allegiance to its state of incorporation.<sup>191</sup> In the case of *Crown Forest Industries Limited v The Queen*<sup>192</sup> the Canadian Federal Court held that, a company created under the laws of the Bahamas was a resident of the USA, under the United States and Canada DTC, because its head office was incorporated in the USA.

The POI residence test would not be able to single out one place of residence in a situation where a company is incorporated in Country T and it divides its management between Country A and Country B, who both claim residence of the company. If a treaty exists between countries A and B, the incorporation tie-breaker test would not fulfil the function of a dual residence tie-breaker test. If the POI test were to be used as a residence tie-breaker test in tax treaties, dual residence would still eventuate in tax treaties and double taxation would still occur in international tax.<sup>193</sup>

The POI test may have no connection with an entity's actual economic business links such as the location of its assets. Such a connection may be randomly chosen by a

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<sup>188</sup> The United States Model Tax Convention of 2006

<sup>189</sup> Guglielmo Maisto (ed) *Residence of Companies under Tax Treaties and EC Law* (2009) 282, Art 4(3) of the US Model Income Tax Convention 2006.

<sup>190</sup> Avi-Yonah et al op cit note 10 at 130. The place of incorporation of company is the place where a company is registered.

<sup>191</sup> Ibid at 154.

<sup>192</sup> 92 D.T.C 6305(1992).

<sup>193</sup> OECD *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001) 152.

taxpayer.<sup>194</sup> Nowadays a company can be incorporated online in any jurisdiction and the company would only have a formal tie to a jurisdiction.<sup>195</sup> Places of incorporation or formation are open to manipulation as they could in theory be changed through a mere formal process, without in reality changing the location of a company.<sup>196</sup>

The POI test has several advantages, it does not require interpretation, has lower compliance costs, avoids litigation costs and is easy to administer.<sup>197</sup> The test provides simplicity and certainty to tax authorities and taxpayers.

The incorporation test is vulnerable to manipulation because companies can easily move their places of incorporation to low taxing jurisdictions<sup>198</sup> and reduce their tax liability. Avi Yonah et al points out that US residents take advantage of the POI test by forming wholly owned foreign corporations that hold their foreign sourced income, causing a tax deferral<sup>199</sup> from the United States.<sup>200</sup> This has resulted in many tax deferral rules being adopted in the US Tax Code.<sup>201</sup> Though the POI test is an easier method to determine the residency of dual resident companies it is not a feasible tie-breaker test because it is susceptible to manipulation.

### **5 3 The Place of Management Test**

In German domestic law, the place of management is the place where top level management is situated and where important policies are actually made.<sup>202</sup> The centre of top level management is also the place where business management activities are carried out by authorised persons.<sup>203</sup> The place where management directives are given is

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<sup>194</sup> Van Der Merwe op cit note 55 at 122.

<sup>195</sup> OECD *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001) 153.

<sup>196</sup> Subhajit Basu *Global Perspectives on E-Commerce Taxation Law* (2007) 38.

<sup>197</sup> Kara Baquizal 'The Challenges of Redefining Corporate Tax Residence in a Global Competitive Market' p7 available at <http://www.fedbar.org/Image-Library/Sections-and-Divisions/Tax/2012-taxlawcomp-1st.aspx?FT=.pdf> accessed on 4 March 2013.

<sup>198</sup> Basu op cit note 196 at 185.

<sup>199</sup> Postponement of taxation until a later date, taxes which result from financial accounting but are not yet incurred under tax accounting legislation, Mehnert *The Accounting of Deferred Taxes under IFRS* 2009.

<sup>200</sup> Avi Yonah et al op cit note 10 at 154.

<sup>201</sup> Ibid.

<sup>202</sup> Vogel *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income* (1997) 3 ed 262.

<sup>203</sup> OECD *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001) 148.

decisive of the place of management of an entity.<sup>204</sup> The place of management test would not be a suitable residence tie-breaker test in treaties in cases where management directives are given in various locations by top level management.

#### **5 4 Mutual Agreement Procedure**

The residence of a company can be determined by competent authorities of treaty contracting states by mutual agreement.<sup>205</sup> In deciding the residence of a company, tax authorities can have regard to the company's POEM, POI and any other relevant factors.<sup>206</sup> Factors such as the meeting place of the board of directors, the place where senior executive officers conduct company business, the location of a company's headquarters, the domestic laws that govern a corporation, the place where the company's financial books are stored.<sup>207</sup> The OECD commentary suggests that competent authorities of contracting states should state the time period in which a residency decision will have effect.<sup>208</sup>

Vogel prefers the use of the mutual agreement procedure to solve cases of corporate dual residence, in the absence of other guides in a treaty. He contends that a residency decision should be taken in line with the residence criteria in the domestic laws of contracting states.<sup>209</sup> It is easier for competent authorities to determine residence in accordance with their domestic laws.

The mutual agreement test has shortfalls despite its flexibility. Taxpayers are not able to assess their tax status and liability until a residence decision is reached by competent authorities of treaty contracting states. There is no enforced obligation on competent authorities to reach a residence decision. Until a residence decision is reached by competent authorities a dual resident corporation would not be entitled to any treaty benefits.<sup>210</sup> Denying dual resident companies treaty benefits serves to prevent shareholders from deliberately creating dual resident companies for tax planning

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<sup>204</sup>Ibid.

<sup>205</sup> Commentary on Art 4(3) of the OECD Model Tax Convention on Income and on Capital pC(4)-9 para3.

<sup>206</sup>Ibid.

<sup>207</sup>Ibid.

<sup>208</sup>Ibid

<sup>209</sup>Vogel op cit note 202 at 267.

<sup>210</sup>Olivier & Honiball op cit note 6 at 40.

purposes.<sup>211</sup> The mutual agreement procedure is not administratively feasible and it opens up the door to ‘arbitrary and intransigent behaviour compounded by the secrecy of the process’,<sup>212</sup> this may result in profound consequences for contracting states and no remedies for taxpayers.<sup>213</sup>

## **5 5 The Place of Central Management and Control Test**

### **5 5 1 UK Concept of the Place of Central Management and Control**

The UK case of *De Beers Consolidated Mines V Howe*<sup>214</sup> gave birth to the place of CM&C test which stipulates that the residence of company is the place where the real business of a company is carried on.<sup>215</sup> The case concerned De Beers, a company incorporated in South Africa and it was controlled by its board of directors in the United Kingdom.<sup>216</sup> The De Beers Company had diamond mines, its headquarters and held its general shareholder meetings in South Africa.<sup>217</sup> The Court considered the residence of the majority of the company’s senior directors, the location in which actual control of the company was exercised and the place where majority voting rights were controlled<sup>218</sup> to determine the real business of the De Beers. The Court held that De Beers was resident in the UK because the majority of its directors exercised management powers and made policy decisions in the United Kingdom.

It is argued that the ruling in the *De Beers* case is not applicable in the twenty-first century where business is conducted in various ways<sup>219</sup> because the real business of a company can be carried on in various places. Schwarz points out that determining the place of management and control of a company is a question of fact.<sup>220</sup>

In cases where full powers of management and control rest in the board of directors, the place where they meet to decide on policy, finance and related matters is

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<sup>211</sup>Vogel op cit note 202 at 268.

<sup>212</sup>Schwarz op cit note 9 at 130.

<sup>213</sup> Ibid.

<sup>214</sup> (1906) AC 455.

<sup>215</sup>Schwarz op cit note 9 at 120.

<sup>216</sup> *De Beers Consolidated Gold Mines V Howe* (1906) AC 455.

<sup>217</sup> Ibid

<sup>218</sup> Ibid.

<sup>219</sup> Online business , multi-national business, Olivier & Honiball op cite note 6 at 39.

<sup>220</sup>Schwarz op cit note 9 at121.

the place of CM &C of the company.<sup>221</sup> Outside persons<sup>222</sup> that interfere with company decisions, do not affect the determination of the residence of an entity.<sup>223</sup> The main inquiry in the determination of corporate residence should be solely on persons who make the supreme management decisions of a company.<sup>224</sup> Only actual exercise of company management and control rather than unexercised decision making power should be determinative of the place of CM &C of a company.<sup>225</sup> When ascertaining the place of CM &C of a company the memorandum and articles of association of the company are not conclusive of its place of central management and control.<sup>226</sup> The reason for not considering the memorandum and articles of association of a company as indicative of the place of CM &C of a company would likely be that persons with management powers on paper might be different from the persons who actually exercise management of the company.<sup>227</sup>

In *Unit Construction Co Ltd V Bullock*<sup>228</sup> subsidiary companies registered in Kenya were held to be UK tax residents because the place of CM& C of the subsidiaries was located in the UK. The *ratio decidendi* was that the Kenyan directors did not exercise any real discretion in making decisions and received their instructions from management in the UK.<sup>229</sup> The UK directors exercised actual control of the company. The case highlights that the place of CM &C of a company is located where the board of directors hold their meetings and only authorized management and control of a company is relevant when determining the place of CM&C of a company.

The place of CM &C test elucidated in the *Unit Construction*<sup>230</sup> case can be manipulated by companies. A company can change the meeting place of its board of directors. The interpretation of the place of CM &C test in the *Unit Construction* case would not reveal the place in which actual management of a company is conducted

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<sup>221</sup> *Imperial Continental Gas Association V Nicholson* (1877) ITC 138.

<sup>222</sup> Persons who are not part of a company.

<sup>223</sup> *Mitchell V Egyptian Hotels Ltd* 1915( 6)TC 152

<sup>224</sup> *Ibid.*

<sup>225</sup> *Egyptian Delta Land and Investment Company Ltd v Todd* (1928) 14 TC 119.

<sup>226</sup> *Unit Construction Co. Ltd V Bullock* (1960) AC 531.

<sup>227</sup> R C Williams *Capital Gains Tax: A Practitioner's Guide Manual* 2ed( 2005)13.

<sup>228</sup> (1960) A.C 351.

<sup>229</sup> *Unit Construction* supra note 226.

<sup>230</sup> (1960) AC 531

because the meeting place of the board of directors might not necessarily be the place where actual management decisions are made. In certain cases, important company management decisions can be made by lower or intermediate company management and not by the board of directors.

In Canadian jurisprudence, the meeting place of the board of directors of a company is a rebuttable presumption when establishing the residence of a company.<sup>231</sup> The onus is placed on a company to prove its place of real management. This is a secure approach because; the facts and circumstances of a case might reveal that company decisions were *de facto* made outside board meetings, hence the place of CM &C of a company will not be located at the meeting place of the board of directors.

For the meeting place of the board of directors to be determinative of the place of CM &C of a company, substantive business and management decisions must be made in its board meetings.<sup>232</sup> The place of CM&C test does not solve the problem of corporate dual residence, because management decisions can be made by a board of directors in different locations through Skype, hence the place of CM &C of an entity can be divided geographically.<sup>233</sup> The UK concept of the place of CM&C would not single out a sole place of residence for a dual resident company, in cases where company management located in different countries make substantial company decisions through telecommunications.

UK Revenue acknowledged that the interpretation of the place of CM &C of a company as the meeting place of a board of directors might not always be indicative of the place of CM& C of a company. The UK Statement of Practice of 1990 now considers the meeting place of the board of directors to be important and not decisive of the place of CM&C of a company,<sup>234</sup> in cases where a controlling individual makes company decisions, the residence of that individual is considered to be the residence of

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<sup>231</sup> Avi Yonah et al op cit note 10 at 135.

<sup>232</sup> Avi Yonah et al op cit note 10 at 137.

<sup>233</sup> Schwarz op cit note 9 at 121.

<sup>234</sup> UK Revenue Statement of Practice 1/90 Company Residence available at <http://www.hmrc.gov.uk/manuals/intmanual/intm120200.htm> accessed 1 June 2013.

the company.<sup>235</sup> In cases where the central management and control of a company is located in different places, the place in which acts of controlling power and authority are exercised to some substantial degree should be deemed to be the place of CM &C of a company in order to attain a single place of residence for corporations.<sup>236</sup>

In the UK case of *Wood V Holden*<sup>237</sup> the issue was whether or not “Eulalia” (a Dutch company) was a UK tax resident in terms of the DTA between the UK and the Netherlands. The court decided that Eulalia was resident in the Netherlands.<sup>238</sup> The reason for the decision was that Eulalia’s sole managing director signed and executed documents in the Netherlands.<sup>239</sup> The court highlighted that the place of CM &C of a company lies in the state where its board of directors meet with the exception of cases where the directors are in fact deprived of their power to exercise central management and control of a company.<sup>240</sup> The court held that an effective decision as to whether or not resolutions should be passed and the signing of documents or execution of decisions with some minimum level of information should be regarded as company management.<sup>241</sup> In circumstances where a board of directors merely approves decisions and does not in substance make company decisions; the place where the decision maker resides is considered to be the place of CM &C of the company.<sup>242</sup>

The place of CM &C test interpretation adopted in the *Wood* case would be a preferable residence tie-breaker test in tax treaties because it is objective and does not focus only on company management as representing the place of CM &C of a company. Although the interpretation of the place of CM&C test elucidated in the *Wood* case is objective the interpretation would not be a suitable tie-breaker residence test in tax treaties. It does not counteract the problem of corporate dual/multiple residence caused by the use of telecommunication in cases where board meetings are conducted by video

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<sup>235</sup> Ibid.

<sup>236</sup> Russo & Fontana op cit note 12 at 198.

<sup>237</sup> [2006] ECWA Civ 26.

<sup>238</sup> *Wood V Holden* [2006] ECWA Civ 26 para 50.

<sup>239</sup> Ibid para 42.

<sup>240</sup> Ibid para 27.

<sup>241</sup> Ibid para18.

<sup>242</sup> Russo & Fontana op cit note 12 at 199-200.

conferencing or through other forms of telecommunication. In this regard the test would still be susceptible to manipulation.

### **5 5 2 Australian Concept of the Place of Central Management and Control**

In the Australian case of *Kotaike Para Rubber Estates Ltd V Federal Commissioner of Taxation*,<sup>243</sup> the place of CM &C of a company was held to be located at the meeting place of the directors, provided that their resolutions were not subject to consent of or approval by another body of persons.<sup>244</sup> The case concerned an Australian incorporated company which held its board meetings in Australia but had its business operations in Papua Guinea.<sup>245</sup> The court took into consideration the domicile of the directors of the company, the place where the board meetings took place, the place where the company's policy was developed, the place where decisions to distribute dividend were taken, the place where the company's bank account was held and the place where the company's books and corporate seals were taken<sup>246</sup> when it determined the place of CM &C of the company.

The interpretation of the place of CM &C test as the place where high level company decisions are taken might not necessarily coincide with the place where directors make company decisions.<sup>247</sup> The meeting place of the board of directors is usually indicative of the place of CM &C of a company; the court in this case regarded the place of residence of directors as determinative of the residence of a company.<sup>248</sup> The interpretation of the place of CM&C as the place of residence of directors would only be a suitable residence tie-breaker test, if all company directors reside in one country.

### **5 5 3 Conclusion of the Place of CM&C tests**

The Canadian jurisprudence consideration of the meeting place of the board of directors as a rebuttable presumption when determining the place of CM& C of a company would be a suitable corporate dual residence tie-breaker test in tax treaties. A company would

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<sup>243</sup> (1941) 64 C.L.R.

<sup>244</sup> *Kotaike Para Rubber Estates Limited V Federal Commissioner of Taxation*(1941) 64 C.L.R at p15.

<sup>245</sup> *Ibid* at p16.

<sup>246</sup> *Ibid* at p16-17.

<sup>247</sup> *Malayan Shipping Co Ltd V Federal Commissioner of Taxation* (1946 ) 71 CLR 156.

<sup>248</sup> *North Australian Pastoral Co Ltd V Federal Commissioner of Taxation* (1946) 71 CLR 623.

have to prove its real and actual place of management, as its place of residence. A defined set of objective and subjective factors that are compatible with use of telecommunication would still have to be produced as guidelines for the determination of the place of CM&C test, to be a suitable residence tie-breaker in tax treaties. The highlighted factors<sup>249</sup> in the central management and control cases<sup>250</sup> would still be viable and authoritative guides to determine the residence of dual resident corporations. The factors would have to be weighed in totality when utilising the place of CM &C test as a tie-breaker in tax treaties.

## **5 6 Conclusion**

The outlined tests are not suitable as dual residence tie-breaker tests in tax treaties because they do not adequately single out one place of residence in cases of corporate dual residence and do not counteract the multiple residence problem caused by the use of telecommunication by companies. The mutual agreement procedure seems to be preferable residence test that can allocate a single place of residence for dual resident companies. In practice the mutual agreement procedure has administrative problems and prolonged time periods will foreseeably occur in reaching a residence decision between competent authorities of contracting states.

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<sup>249</sup> Meeting place of the board of directors, place of residence of majority directors, the place of residence of the person who exercises actual control of the company, the place where company books and corporate seals are taken, the place where the company decision maker resides.

<sup>250</sup> *Unit Construction* supra note 226, *Kotaiki Para Rubber Estates* supra note 244, *Wood* supra note 238.

## Chapter 6

### 6 1 Conclusion and Recommendation

The Commentary on Article 4(3) of the OECD MTC does not provide an adequate description/ interpretation of the POEM dual residence tie-breaker test. It does not describe the type of key management and commercial decisions that are determinative of the POEM of a dual resident entity. Daily operational company decisions<sup>251</sup> or policy and strategic management decisions can be determinative of the POEM of an entity.<sup>252</sup> The OECD Commentary also does not provide guidelines of the facts and circumstances that have to be considered to determine the POEM of a dual resident entity.

The POEM test has different interpretations it can be interpreted as the place where daily management of a company takes place;<sup>253</sup> or the location of the realistic positive management of a company;<sup>254</sup> or the meeting place of a company's board of directors;<sup>255</sup> or the location of a company's central mind and management.<sup>256</sup> The interpretations of the POEM test as the place where daily company management takes place or as the meeting place of a company's board of directors will not single out one POEM for dual resident companies. In cases where daily company management is spread across different jurisdictions the POEM of a dual resident company would not be ascertainable. The interpretation of the POEM test as the meeting place of a company's board of directors would not locate a dual resident

The OECD's interpretation of the POEM test as the place where 'key management and commercial decisions' of a company are made can be manipulated by corporate taxpayers. Company management can abruptly change the place where they

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<sup>251</sup> Harris & David Olivier op cit note 49 at 66.

<sup>252</sup> *Laerstate* supra note 104 at p24

<sup>253</sup> Van Blerk and Horak as cited by Oliver and Honiball op cit note 6 at 28

<sup>254</sup> *Laerstate* at p42

<sup>255</sup> *Tradehold* supra note 59, *Unit Construction* supra note 531, Meyerowitz on Income Tax 2003-2004 para 5.19

<sup>256</sup> Westin op cit note 11 at 559.

make decisions. If company management shifts its decision making process to a low taxing jurisdiction, it would successfully reduce the tax liability of a company. This could motivate corporations to create schemes in which they would constantly shift the place where they make decisions in order to avoid tax or incur lower taxes.

The SARS interpretation of POEM as the place where daily company management is conducted by directors or senior managers would not be a suitable dual residence tie-breaker test for companies. Daily management of an entity can be implemented in different places and this might result in dual residence and double taxation would likely occur. Although the SARS interpretation of the POEM is informative and outlines the facts and circumstances that have to be taken into account to determine the POEM, the SARS facts and circumstances criterion still needs to be clarified and refined.

The main inquiry when determining the place of residence of a company should be to establish the actual place where a company is managed and controlled. The interpretation of the POEM test as the place where the central mind and management<sup>257</sup> of a company is located presents an objective approach to determine the residence of a company. This interpretation of the POEM requires an examination of facts to determine the actual controlling body and management of a company. Such an approach should be adopted when formulating treaty residence tie-breaker tests. Ultimately any interpretation given to the phrase “effective management” has to be weighed and tested against the treaty tie breaker purpose which promotes single tax residence for companies and non- individual persons.<sup>258</sup>

The corporate considerations highlighted in the *Laerstate* case and the suggested facts and circumstances highlighted in Chapter 3 would be useful to determine the POEM of a dual resident company. Factors such as the meeting place of the board of directors, the place of management and control of a corporation, the place of implementation of management and commercial decisions of an entity must be considered to determine the residence status of a dual resident company but they should not be decisive.

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<sup>257</sup> Ibid.

<sup>258</sup> Van Der Merwe op cit note 43 at 92.

The various tests<sup>259</sup> used to determine residence are not viable as dual residence tie-breaker clauses in treaties. They are subject to manipulation by taxpayers and do not promote the notion of single residence in tax treaties; hence they cannot be used in tax treaties. The application of these tests does not eliminate dual residence but rather multiply places of residence for dual resident companies.

It is rather feasible to adopt a hierarchy of tests suggested by TAG in its draft document of 2003, in tax treaties and models conventions as a dual residence tie-breaker test for companies and non-individual persons. The hierarchy of tests tries to provide solutions for most cases of dual residence. The hierarchy is made of the following tests;<sup>260</sup>

- The POEM as the first preference tie-breaker residence test for a dual resident entity.
- Alternative A; the economic nexus rule, Alternative B; the place where a business conducts its activities , Alternative C; the place where an entity's senior executive decisions are taken. These three alternatives are the second preference tie-breaker tests for dual resident entities.
- The place of incorporation, as the third preference dual residence tie-breaker test for dual residence entities.
- Lastly, taxing authorities of contracting states should make use of a mutual agreement procedure to solve the problem of dual residence.

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<sup>259</sup> Incorporation , Management and Control, Central Management and Control.

<sup>260</sup> OECD Discussion Draft: Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention 2003 p3 Para (a)-(d).

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A Minor Dissertation presented in partial fulfilment of the  
Requirements for the Degree of Masters of Law in Taxation by  
Vimbai Tanyanyiwa (TNYVIM001)

An Analysis of the Simulation Concept in South African Tax  
Law; '*Commissioner of the South African Revenue Service V  
NWK Ltd*'

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## 1 Introduction

The *NWK*<sup>1</sup> case has generated much debate in South African tax jurisprudence. The case dealt with the substance over form doctrine, in particular the simulation principle. The substance over form doctrine is also known as the '*plus valet quod agitur quam quod simulate concipitur*' rule.<sup>2</sup> In terms of the doctrine, a court will not give effect to the form of an agreement if the agreement does not reflect the parties' true intention.<sup>3</sup> The substance over form doctrine consists of two principles, the label principle and the simulation principle.<sup>4</sup> The simulation principle refers to a situation where parties to a transaction purposefully hide or conceal the true nature of their transaction;<sup>5</sup> courts of law do not recognize simulated or 'disguised' transactions.<sup>6</sup> The label principle refers to a situation where parties to a transaction 'act in good faith'<sup>7</sup> but they put a wrong label on their transaction.<sup>8</sup>

At issue in the *NWK* case was a dispute over interest deductions made by *NWK*, a public company in terms of S11(a) of the Income Tax Act<sup>9</sup> on a structured finance facility loan. The Supreme Court of Appeal had to determine whether a portion of the interest deductions made by *NWK* were not deductible by reason of the loan being simulated. To establish simulation in the *NWK* case, the Supreme Court of Appeal extended the traditional test used to determine simulation.<sup>10</sup> Critics of the judgment say that the court changed the test to determine simulation<sup>11</sup> because the Supreme Court of Appeal in the *NWK* case introduced a new requirement to

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<sup>1</sup> *Commissioner for South African Revenue Service V NWK Ltd* 2011 (2) SA 67 (SCA).

<sup>2</sup> Lynette Olivier & Michael Honiball *International Tax : A South African Perspective* (2011) 5ed 514.

<sup>3</sup> Oliver & Honiball *International Tax: A South African Perspective* (2011) 5ed 514 para 2.1.

<sup>4</sup> Trevor Emslie, Dennis Davis, Sally Hutton Lynette Olivier *Income Tax: Cases and Materials* 3ed (2001) 897.

<sup>5</sup> *Ibid.*

<sup>6</sup> *Ibid.*

<sup>7</sup> *Ibid.*

<sup>8</sup> *Ibid.*

<sup>9</sup> S11(a) of the Income Tax Act 58 of 1962 allows deductions from the income of any person carrying on trade expenditure and losses actually incurred in the production of income, which are not of a capital nature for purposes of determining the taxable income of a person.

<sup>10</sup> The case of *Zandberg V Van Zyl* 1910 AD 302 laid down the test used to determine if a transaction is simulated which involves a determination of whether parties to an agreement intended their agreement to have effect according to its terms and a factual inquiry of a case to ascertain the intention of parties to an agreement. This principle has been used in a number of court decisions to determine simulation. The test has been used in the following cases: *Erf Ladysmith v Commissioner for Inland Revenue* 1996 (3) 942, *Commissioner of Customs and Excise V Randles Brothers & Hudson Ltd* 1941 AD 369

<sup>11</sup> *NWK* supra note 1 para 55.

establish simulation which is in conflict with established principles in the law relating to simulated transactions.<sup>12</sup>

The traditional test used to determine simulation is ‘whether parties to an agreement genuinely intended their agreement to have effect according to its tenor’.<sup>13</sup> Before a court concludes that an agreement is simulated there has to be a ‘real, definitely ascertainable intention which differs from the simulated intention’.<sup>14</sup> This was the law applied to determine simulation in cases prior the *NWK* case and these cases will be reviewed in this paper. The Supreme Court of Appeal in the *NWK* case stated that the test to determine simulation should not only focus on parties intention to give effect to an agreement according to its terms<sup>15</sup> but should ‘go further and require an examination of the commercial sense of a transaction: of its real substance and purpose’.<sup>16</sup> The Supreme Court of Appeal further stated that transactions that have a sole purpose of evading ‘tax or a peremptory law should be regarded as simulated’.<sup>17</sup> In the *NWK* case, the parties to the loan agreement had performed the agreement according to its terms but the court was of the view that performance of the agreement did not prove or show that the transaction was not simulated. The Court stated that performance of the agreement was a charade ‘meant to give credence [to the parties] simulation’.<sup>18</sup>

The purpose of this paper is to analyse the *NWK* judgment and to determine if the *NWK* judgment has changed the concept of simulation in South Africa. The paper will also discuss the correctness of the extended simulation test and address the court’s justification for extending the traditional simulation test.

This paper takes the following structure;

**Chapter 2** provides an overview of the law relating to simulated transactions before the *NWK* judgment. The chapter also describes the manner in which courts determined simulation before the *NWK* case.

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<sup>12</sup> Eddie Broomberg ‘*NWK* and Founders Hill’ *The Taxpayer Journal* (2011) 60 198-199, Broomberg is of the opinion that the Supreme Court in the *NWK* case created a new test to determine simulation by stating that transactions that have a sole of purpose of evading tax should be regarded as simulated, this statement is contrary to the principle that even when parties conclude an agreement with the purpose of avoiding or evading tax such a transaction cannot be regarded as simulated.

<sup>13</sup> *Zandberg V Van Zyl* 1910 AD 309, *Commissioner of Customs and Excise V Randle Brothers & Hudson* 1941 AD 396.

<sup>14</sup> *Zandberg* supra note 13 at 309.

<sup>15</sup> *NWK* supra note 1 para 55.

<sup>16</sup> *Ibid.*

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.*

**Chapter 3** provides the facts, arguments and the judgment of the *NWK* case in the Tax Court and in the Supreme Court of Appeal. The chapter also analyses the Supreme Court's justification for extending the traditional simulation test in the *NWK* case.

**Chapter 4** discusses the correctness of the simulation test formulated in the *NWK* case and determines if the *NWK* judgment has changed the concept of simulation in South Africa.

**Chapter 5** provides a conclusion of the research.

## 2 The Law before the *NWK* case

For purposes of understanding the simulation test formulated in the *NWK* case, it is important to give a description of the manner /method which courts used to determine simulation before the *NWK* case.

It is an accepted principle of law that taxpayers are permitted to structure their financial arrangements in any manner so as to reduce their tax liability.<sup>19</sup> A taxpayer is also entitled and can choose to realize his aims and financial matters in any tax efficient manner.<sup>20</sup> Although taxpayers can efficiently structure their financial affairs so as to reduce their tax liability they cannot achieve this by simulating agreements.<sup>21</sup> Courts will not be deceived by the appearance or structure of an agreement;<sup>22</sup> they will examine its true nature and attach the ‘adequate tax implications to it’.<sup>23</sup>

Before the *NWK* judgment a simulated transaction was defined as a dishonest transaction which had a feigned appearance.<sup>24</sup> A simulated transaction was generally understood to be a disguised transaction,<sup>25</sup> and some authors have stated that determining simulation is ‘subjective and involves an inquiry of parties intention to deceive’.<sup>26</sup> A transaction was also regarded as simulated if parties to an agreement deliberately concealed their true intention to the agreement.<sup>27</sup>

The cases of *Zandberg V Van Zyl*<sup>28</sup> and *Commissioner of Customs and Excise V Randles Brothers & Hudson*<sup>29</sup> elucidated important principles with regard to simulated transactions. In the *Zandberg* case the court stated that the test to determine simulation, involves a factual inquiry of a case to ascertain the actual intention of parties to an agreement.<sup>30</sup> The court also stated that before a transaction is said to be simulated, there has to be a ‘real, ascertainable intention which differs

<sup>19</sup> *Inland Revenue Commissioners V The Duke of Westminster* 1936 AC at p19.

<sup>20</sup> AP De Koker & RC Williams *Silke on South African Income Tax* August 2013 para 19.3.

<sup>21</sup> *Relier (Pty) Ltd V Commissioner for Inland Revenue* 1997 (SCA) 60.

<sup>22</sup> *Kilburn V Estate Kilburn* 1931 AD 501 at 507.

<sup>23</sup> Thabo Legwaila ‘Modernising the ‘Substance Over Form Doctrine: Commissioner for the South African Revenue Service V *NWK*’ (2012) *SA Merc LJ* 115, *Dadoo Ltd V Kruger Municipal Council* 1920 AD 530, *Secretary for Inland Revenue V Hartzenberg* 1966 (1) SA 405 (A), *Commissioner for Inland Revenue V Saner* 1927 TPD 162.

<sup>24</sup> *Randle Brothers* supra note 13 at 396.

<sup>25</sup> *Zandberg* supra note 13 at 309.

<sup>26</sup> Trevor Emslie ‘Simulated Transactions – *NWK* Revised’ (2011) 60 *The Taxpayer Journal* 24.

<sup>27</sup> *CIR V Collins* 1923 AD 437.

<sup>28</sup> 1910 AD 302.

<sup>29</sup> 1941 AD 396.

<sup>30</sup> *Zandberg* supra note 13 at 302, *Randle Brothers* supra note 13 at 369.

from the written or simulated intention'.<sup>31</sup> In the *Randle Brothers* case, the court stated that the mere fact that parties enter into an agreement with the object of avoiding tax or evading a prohibition in an Act,<sup>32</sup> does not mean that the agreement is simulated.<sup>33</sup> The court further stated that, such an agreement has to be interpreted according to its tenor,<sup>34</sup> and a court has to determine whether the transaction is taxable or whether it falls within a statutory prohibition.<sup>35</sup> These principles have been used in various cases that dealt with the subject of simulated transactions.

An agreement can be partly or fully simulated.<sup>36</sup> A fully simulated contract arises where all the parties to a contract do not intend to perform the contract according to its legal terms and obligations.<sup>37</sup> A partly simulated contract arises where one party to a contract or series of transactions does not know that the other party has no intention of performing the agreement according to its terms, its agreement with the other parties cannot be said to be simulated.<sup>38</sup>

Prior the *NWK* case, if parties to an agreement gave effect to the terms of their agreement, such an agreement was not regarded as simulated<sup>39</sup> but if parties had given effect to an unexpressed agreement or a different intention than that stated in their agreement, such a transaction was regarded as simulated.<sup>40</sup> The test to determine simulation is in essence a test to determine the true intention of parties in entering into an agreement, so as to ascertain the true nature of an agreement. To determine this intention, courts have conducted 'an objective review of all the relevant facts and circumstances of a case'<sup>41</sup> i.e. the circumstances before the conclusion of an agreement, the position of the parties to an agreement, the form of a transaction and the implementation of an agreement.<sup>42</sup>

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<sup>31</sup> *Zandberg* supra note 13 at 302.

<sup>32</sup> *Randle Brothers & Hudson* supra note 13.

<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

<sup>36</sup> De Koker & Williams op cit 20 at para 19.3

<sup>37</sup> *Ibid.*, De Koker and Williams state that the point that a transaction can be fully simulated not been expressly accepted by South African courts but it has been implied by the *Zandberg* case

<sup>38</sup> *Ibid.*

<sup>39</sup> *ITC 1636 60 SATC 267* reported on Appeal as the *Conhage* case parties to lease and sublease agreements performed the agreements according to their terms and proved that they had a genuine intention to perform the agreements- their agreements were not regarded as simulated.

<sup>40</sup> *Zandberg* supra note 13 at 302.

<sup>41</sup> *ITC 1185 1972 35 SATC 122, Michau V Maize Board 2003(6) SA 459 (SCA) para 4, Maize Board V Jackson 2003 (6) 592 (SCA) para 7, CIR V Saner 1927 TPD 162, SIR V Hartzberg 1966 (1) SA 405.*

<sup>42</sup> Innes J and De Villiers CJ in *Zandberg V Van Zyl* 1910 AD at 308, 309, 310 made reference to case of *Beckett V Tower Asset Co* (1891, 1 Q.B) where the court stated all relevant circumstances of a

In *Zandberg* case, the true nature of a sale agreement was in dispute. To determine the actual intention of the parties in concluding the agreement, the court considered the circumstances before the conclusion of the agreement, the substance / legal rights that emanated from the agreement and the implementation of the sale agreement.<sup>43</sup> The court found that the circumstances of the case indicated that the parties intended to conclude a pledge agreement and not an agreement of sale.<sup>44</sup> In this case, the seller retained ownership of wagon which it had sold to another person.<sup>45</sup> The court held that the parties had disguised a contract of pledge under the form of a sale and ruled that the agreement was simulated.<sup>46</sup>

In *ITC 1636*, reported on Appeal as *Commissioner for Inland Revenue v Conhage*<sup>47</sup> concerned the legitimacy of sale and leaseback agreements. The court considered; the background of the sale and leaseback agreements, the consultations that had occurred between the parties, the object that the parties wanted to realise by concluding agreements of sale and leaseback, the commerciality of the transaction, the risks associated with concluding agreements of sale and leaseback and the ‘manner of implementation of the agreement’<sup>48</sup> to determine the intention of the parties in concluding agreements of sale and leaseback. The court held that the sale and leaseback agreements reflected the parties’ true intention and held that the agreements were not simulated.<sup>49</sup>

In *ITC 1171*,<sup>50</sup> the Tax Court had to determine the validity of a restraint of trade agreement. The CSARS<sup>51</sup> contended that the agreements were cloaked and were in truth payment for services rendered.<sup>52</sup> The court looked at the background of the transactions, the manner of implementation of the agreement and the conduct of the parties after the conclusion of the agreement to determine the intention of the parties in entering into a restraint of trade agreement.<sup>53</sup> The Court held that the

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case should be considered to determine the actual intention of parties to an agreement and the true nature of an agreement.

<sup>43</sup> Innes J in *Zandberg V Van Zyl* 1910 AD 309-314.

<sup>44</sup> Solomon J in *Zandberg V Van Zyl* 1910 AD 302.

<sup>45</sup> *Zandberg* supra note 13 at 302.

<sup>46</sup> *Ibid.*

<sup>47</sup> *CIR V Conhage Pty Ltd* 1999 (4) 1149 (SCA).

<sup>48</sup> *ITC 1636* 60 SATC 267.

<sup>49</sup> *Ibid.*

<sup>50</sup> [2006] ZATC (8) (13 December 2006).

<sup>51</sup> Commissioner for South African Revenue Services.

<sup>52</sup> *ITC 11711* [2006] ZATC (8) (13 December 2006) para 7&14.

<sup>53</sup> *Ibid* para 64.

agreements were a true reflection of the taxpayers' intention and were not simulated.<sup>54</sup>

In cases prior the *NWK* case, courts looked at all the relevant facts and circumstances of a case to determine the true intention of parties to an agreement. Courts used objective factors i.e. the facts and circumstances of a case to determine intention.<sup>55</sup> As illustrated from the cases highlighted in this chapter, the test to determine simulation is in essence, a test to determine the true intention of parties to an agreement. Ascertaining a party's intention in entering into an agreement is purely factual hence it results in different outcomes depending on the facts and circumstances of a case.

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<sup>54</sup> *Ibid* para 66.

<sup>55</sup> *Michau V Maize Board* 2003 (6) SA 459 para 4, *Maize Board V Jackson* 2005 (6) 592 (SCA) para 7.

### 3 ‘Commissioner of the South African Revenue Services V NWK’

The purpose of this chapter is to present the facts and the arguments of the parties in the *NWK* case. The Tax Court judgment of the *NWK* case will be outlined in this chapter. The judgment of the *NWK* case and the court’s justification/ reason for extending the traditional simulation test in the *NWK* case will also be analysed in this chapter.

#### 3 1 Facts

The main dispute in the *NWK* case was the correctness of interest deductions made by *NWK* on a loan of R96 million. The R96 million loan agreement consisted of five transactions. Slab Trading Company Pty Ltd (Slab), a subsidiary of FNB lent *NWK* a loan of R96 million which was repayable over a period of five years.<sup>56</sup> *NWK* repaid the loan by delivering 109 315 tons of maize to Slab by means of constructive delivery.<sup>57</sup> *NWK* and FNB signed silo certificates in the presence of a notary to effect delivery of the maize.<sup>58</sup> The loan capital was ‘subject to interest at a fixed rate of 15.27 per annum’<sup>59</sup> and the interest was payable every six months.<sup>60</sup> *NWK* issued promissory notes of a sum of R74 686 861 , as payment of the loan interest.<sup>61</sup>

First Derivatives a division of FNB sold 109 315 tons of maize to *NWK* for an amount of R46 415 776 and delivery of the maize was constructive.<sup>62</sup> *NWK* paid R46 415 776 to First Derivatives.<sup>63</sup> Slab also sold 109 315 tons of maize to First Derivatives and delivery of the maize was constructive.<sup>64</sup> Slab also sold its right to the promissory notes to FNB for R50 967 518.<sup>65</sup>

*NWK* transferred its right to deliver maize to Slab ( in terms of the R96 million agreement) to FNB and FNB also took possession of Slab’s ‘right to claim

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<sup>56</sup> *NWK* supra note 1 at para 13.

<sup>57</sup> *Ibid*, constructive delivery ‘takes place where the act of transfer of goods is not explicit but where a change occurs in the intention with which goods (a thing) is controlled which indicates the intention that ownership has transferred’. –Andries Johannes Van Der Walt & Gerrit Pienaar *Introduction to the Law of Property* (2009) 6ed 129.

<sup>58</sup> *NWK* supra note 1 at para 21.

<sup>59</sup> *Ibid* para 15.

<sup>60</sup> *Ibid*.

<sup>61</sup> *Ibid*.

<sup>62</sup> *Ibid* para 16.

<sup>63</sup> *Ibid*.

<sup>64</sup> *Ibid* para 17.

<sup>65</sup> *Ibid* para 18.

delivery of maize from NWK'.<sup>66</sup>This resulted in *confusio*<sup>67</sup> and this process extinguished NWK's right to deliver maize to Slab, which in effect was repayment of the R96 million loan.

Over the five year loan period NWK paid interest of the amount of 'R74 686 861 , the face value of the promissory notes'.<sup>68</sup> It also claimed and was granted interest deductions from its income in terms of S11(a) of the Income Tax Act<sup>69</sup> from 1999 to 2003. The CSARS<sup>70</sup> disallowed the interest deductions made by NWK on the R96 million loan<sup>71</sup> and imposed additional tax assessments on NWK on grounds that the R96 million loan agreement did not reflect the 'true substance of the transaction'<sup>72</sup> between NWK and FNB.<sup>73</sup> The Commissioner also imputed additional tax and interest in terms of S76 & 79 of the Income Tax Act<sup>74</sup> on NWK's tax assessments, on the basis that NWK had misrepresented in its tax forms that payment of the promissory notes constituted payment of interest when it also constituted payment of capital to Slab.<sup>75</sup> The Commissioner also imposed additional tax and interest on NWK's tax assessments on grounds that NWK had 'represented that the loan transactions were commercial transactions, in which maize was delivered, when in reality no delivery was ever intended'.<sup>76</sup>

For purposes of understanding the Commissioner's arguments and the court's judgment in the *NWK* case, it should be noted that FNB's loan proposal for the R96 million loan indicated that the transactions that were part of the loan would 'enable NWK to reduce its existing tax liabilities'.<sup>77</sup> Before the conclusion of the R96 million loan Barnard, NWK's Manager had discussed a loan offer of R50 million with FNB.<sup>78</sup> NWK accepted the R50 million loan agreement on the same day that it accepted the R96 million loan from FNB.<sup>79</sup>

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<sup>66</sup>Ibid para 19.

<sup>67</sup>Ibid para 20- '*Confusio* is a process where a right and a corresponding obligation inhere in the same person'.

<sup>68</sup> Ibid para 21.

<sup>69</sup> 58 of 1962 , Ibid para 24.

<sup>70</sup> Commissioner for the South African Revenue Services.

<sup>71</sup> *NWK* supra note 1 at para 25.

<sup>72</sup> Ibid 26.

<sup>73</sup> Ibid.

<sup>74</sup> Income Tax Act 58 of 1962.

<sup>75</sup> *NWK* supra note 1 at para 34.

<sup>76</sup> Ibid para 34.

<sup>77</sup> Ibid para 12.

<sup>78</sup> Ibid para 8.

<sup>79</sup> Ibid Para 23

## 3 2 The Parties Arguments

### 3 2 1 Commissioner's Arguments

The Commissioner's main arguments were that the loan transactions between Slab , NWK , First Derivatives and FNB were designed to hide the actual loan amount lent to NWK of R50 million<sup>80</sup> and that the additional amount (R46 million) of the purported loan of R96 million was simulated with a series of transactions.<sup>81</sup> The Commissioner supported his argument with eight reasons. NWK and FNB never intended to deliver maize as indicated in their loan agreement.<sup>82</sup> NWK knew that the consequences of the forward sales and cessions would result in the cancellation of its right to deliver maize to Slab which in effect was repayment of the R96 million loan.<sup>83</sup> The description of maize in the loan agreement was vague.<sup>84</sup> NWK did not provide any security for the R96 million loan.<sup>85</sup> The parties to the NWK loan agreement did not consider the 'risks associated with the delivery of the maize',<sup>86</sup> after concluding the loan agreement.<sup>87</sup> The R96 million loan was calculated in order to produce a certain amount of interest.<sup>88</sup> Slab and NWK never intended to deliver maize before or after conclusion of the loan agreement.<sup>89</sup>

The Commissioner also stated that Slab had an ephemeral role in the loan agreement and was solely included in the loan transactions for purposes of evading or reducing NWK's liability for income tax.<sup>90</sup> With regard to NWK's interest payments, the Commissioner contended that the amount of the promissory notes issued by NWK was calculated by adding the capital amount of the loan (R50 million) and interest on the R50 million loan of R23 989 343.<sup>91</sup> The Commissioner contended that the promissory notes constituted capital and interest of the actual loan amount of R50 million.<sup>92</sup> The Commissioner also argued that the capital portion of

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<sup>80</sup>Ibid para30.

<sup>81</sup>Ibid para30.

<sup>82</sup>Ibid para 27.

<sup>83</sup>Ibid para 72.

<sup>84</sup>Ibid para 69.

<sup>85</sup> Ibid75 .

<sup>86</sup> Ibid28.

<sup>87</sup> i.e no account was taken of the storage or transportation of the maize.

<sup>88</sup> *NWK* supra note 1at para 89.

<sup>89</sup> Ibid para 27.

<sup>90</sup> Ibid para 30.

<sup>91</sup> Ibid para 31.

<sup>92</sup> Ibid.

the notes was not deductible in terms of 11(a) of the Income Tax Act,<sup>93</sup> as it was not employed in NWK's operational trade.<sup>94</sup>

Alternatively the Commissioner argued that S103(1) of the Income Tax Act<sup>95</sup> was applicable to the NWK loan agreement because the loan transactions were 'abnormal', reduced NWK's tax liability and were concluded for purposes of attaining a tax advantage.<sup>96</sup> It should be noted that the NWK loan agreement was concluded when S103 (1) of the Income Tax Act<sup>97</sup> which dealt with arrangements that have the effect of avoiding tax was still in operation.

### 3 3 2 NWK's Arguments

Refuting the Commissioner's arguments, NWK contended that there was a genuine intention on its part to perform the loan contract according to its terms.<sup>98</sup> NWK claimed that the loan agreement of R96 million reflected its intention<sup>99</sup> and stated that it honestly intended the loan agreement to have effect according to its tenor.<sup>100</sup> Substantiating this argument NWK relied on *S V Friedman Motors (Pty) Ltd*<sup>101</sup> where the court accepted the form of sale and repurchase agreements as representing the actual intention of the parties to the agreements.<sup>102</sup> The parties in the *Friedman* case had entered into agreements of sale and repurchase in order to avoid money lending regulations. Despite this, the parties in the *Friedman* case intended the sale and repurchase agreements to have effect according to their terms.<sup>103</sup>

NWK also argued that the interest deductions on the R96 million loan amount were valid.<sup>104</sup> It contended that its tax returns contained full and accurate information.<sup>105</sup> NWK maintained that there was no unexpressed or hidden agreement on its part which was not recorded in the contract and argued that it was not part of the transactions between Slab and FNB.<sup>106</sup> NWK stated that the R96 million loan constituted the capital sum of R50 million and stated that the balance of

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<sup>93</sup> 58 of 1962.

<sup>94</sup> Ibid.

<sup>95</sup> Ibid.

<sup>96</sup> NWK supra note 1 at para 4 & 33.

<sup>97</sup> 58 of 1962.

<sup>98</sup> NWK supra note 1 at para 3.

<sup>99</sup> Ibid para 35.

<sup>100</sup> Ibid para 57.

<sup>101</sup> 1972 (1) SA 76 (T).

<sup>102</sup> *S V Friedman Motors (Pty) Ltd 1972 (1) SA 76 (T)* at 83D-H.

<sup>103</sup> Ibid.

<sup>104</sup> Ibid para 3.

<sup>105</sup> Ibid para 36.

<sup>106</sup> Ibid para 35.

the loan was added on as a hedge.<sup>107</sup> NWK contended that the capital amount of the loan was R96 million and argued that the interest payments were not of a capital nature.<sup>108</sup> With regard to S103(1) of the Income Tax Act,<sup>109</sup> NWK denied that the loan transaction postponed its liability for tax and it contended that it had concluded the R96 million loan agreement with the intention of attaining loan finance.<sup>110</sup>

### 3.3 The Tax Court's Judgment

The Tax Court based its judgment on the *Conhage* case where a taxpayer entered into unusual sale and leaseback agreements for purposes of attaining capital and taking advantage of the 'tax benefits' of the transaction.<sup>111</sup> In the *Conhage* case the court accepted that the sale and leaseback transactions reflected the taxpayer's intention of entering into agreement of sale and leaseback.<sup>112</sup> Relating the judgment of the *Conhage* case to the *NWK* case, the Tax court accepted that NWK and FNB concluded the R96 million loan agreement to enable NWK to acquire finance for its business and to obtain a tax advantage.<sup>113</sup> The court stated that parties to an agreement can structure their affairs in any manner as long as their intention is reflected in their agreements.<sup>114</sup> Considering this, the Tax Court found that the R96 million loan agreement reflected NWK's and FNB's real intention<sup>115</sup> and upheld the contention that NWK's intention was to perform the loan agreement according to its terms.<sup>116</sup> The Court also accepted that NWK was aware of the transactions between Slab and FNB but was not party to these agreements<sup>117</sup> and stated that 'NWK was not obliged to choose the less tax effective route or structure of financing'.<sup>118</sup> The Court held that NWK had no motive for deception<sup>119</sup> and ruled that the R96 million loan agreement represented NWK's intention.<sup>120</sup>

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<sup>107</sup> Ibid para 78.

<sup>108</sup> Ibid para 36.

<sup>109</sup> 58 of 1962.

<sup>110</sup> Ibid para 36.

<sup>111</sup> *ITC 1833 70 SATC* para 94.

<sup>112</sup> *CIR V Conhage* 1999 (4) SCA 1149 para 9-10.

<sup>113</sup> *ITC 1833 70 SATC* 238 para 94, 100 -102.

<sup>114</sup> Ibid at para 100.

<sup>115</sup> Ibid.

<sup>116</sup> Ibid para 102.

<sup>117</sup> Ibid para 91.

<sup>118</sup> Ibid 96.

<sup>119</sup> Ibid para 98.

<sup>120</sup> Ibid para 100.

### 3 4 The Judgment of the Supreme Court of Appeal

In reaching its decision the Supreme Court of Appeal disregarded NWK's argument that the loan agreements represented the true intention of the parties to the loan agreement, with reference to the case of *Erf 3183/1 Ladysmith (Pty) Ltd V Commissioner for Inland Revenue*,<sup>121</sup> where the court stated that 'mere production of documents' was not sufficient to prove that the NWK loan agreements were not simulated.<sup>122</sup> The court further stated that in terms of S82 of the Income Tax Act,<sup>123</sup> NWK had to prove that the loan agreements were not simulated.<sup>124</sup> Rebutting NWK's reliance on the *Friedman*<sup>125</sup> case and its argument that the loan agreement indicated its true intention, the Supreme Court of Appeal stated that the court in the *Friedman* case accepted the form of the sale and resale agreements as indicative of the true intention of the parties to the agreements, because they had legitimate commercial reasons for arranging their transactions as sale and resale agreements.<sup>126</sup>

In its judgment the Supreme Court of Appeal accepted that the traditional test to determine simulation is 'whether parties intended their agreement to have effect according to its terms',<sup>127</sup> the court extended the traditional simulation test and stated that;<sup>128</sup>

'...the test should go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation'.<sup>129</sup>

The court based its judgment on this principle and questioned;

- NWK's intention to borrow R96 million loan.<sup>130</sup> The court questioned the real purpose of the loan and the commercial sense of the loan agreement. The court also asked if there was a commercial

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<sup>121</sup> 1996 (3) 942 (SCA).

<sup>122</sup> NWK supra note 1 at para 38 -40.

<sup>123</sup> 58 of 1962.

<sup>124</sup> NWK supra note 1 at para 40.

<sup>125</sup> *S V Friedman Motors (Pty) Ltd* 1972 (1) SA 76 (T).

<sup>126</sup> NWK supra note 1 at para 54.

<sup>127</sup> Ibid para 55.

<sup>128</sup> Ibid para 55 and 49.

<sup>129</sup> Ibid para 55.

<sup>130</sup> Ibid para 56.

purpose for structuring the loan in an unusual manner, other than creating a tax benefit for NWK.<sup>131</sup>

- NWK's acceptance of two loans on the same day, one for R50 million and the other for R96 million.<sup>132</sup> The Court stated that NWK had accepted FNB's loan offer for R50 million on 28 February 1998.<sup>133</sup> The court then made an inference that the loan agreement for R96 million was concluded for other objectives and stated that real loan for the real agreement between Slab and NWK was of a R50 million loan.<sup>134</sup>
- The repayment of the loan with maize and stated that such repayment 'raised questions as to what was truly intended'<sup>135</sup> by NWK and FNB.

The court also made an inquiry of NWK's motive to deceive<sup>136</sup> and it stated that NWK must have known that the obligations in respect of the delivery of maize stated in the loan agreement had been extinguished by the process of *confusio*. Hence NWK's intention to perform the loan agreement according to its terms was questionable.<sup>137</sup>

The Supreme Court of Appeal ruled that the loan transaction was simulated and concluded that the real agreement between NWK and Slab was of a R50 million loan.<sup>138</sup> The court's reasons for ruling that the R96 million was simulated were that;<sup>139</sup>

- NWK could not explain the unusual terms of the loan transaction;<sup>140</sup>
- The amount lent to NWK was determined with an objective to produce a certain amount of interest for NWK,<sup>141</sup>
- The maize was not sufficiently described in the loan agreement;<sup>142</sup>

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<sup>131</sup>Ibid para 56-58.

<sup>132</sup>Ibid para 59.

<sup>133</sup>Ibid para 22.

<sup>134</sup>Ibid para 59.

<sup>135</sup>Ibid para 60.

<sup>136</sup>Ibid para 79-8.0

<sup>137</sup>Ibid para 80.

<sup>138</sup>Ibid para90.

<sup>139</sup> Ibid para 89.

<sup>140</sup>Ibid.

<sup>141</sup>Ibid.

<sup>142</sup>Ibid.

- NWK did not give Slab any security for repayment of the R96 million loan;<sup>143</sup>
- NWK knew that the process of *confusio* would result in extinction of its obligation to deliver maize to Slab.<sup>144</sup> Slab's participation in the transactions was ephemeral<sup>145</sup> and
- NWK never intended to deliver maize to Slab in the future.<sup>146</sup>

The court also came to the conclusion that the loan was structured to produce a tax advantage for NWK.<sup>147</sup> The court disallowed part of the interest deductions made by NWK on the R96 million loan, on the basis that the loan transaction concealed the actual loan agreement of R50 million concluded between Slab and NWK.<sup>148</sup> NWK was ordered to pay interest on the actual loan amount and additional tax of 100% was levied on NWK's new tax assessment in terms of Section 76 of the Income Tax Act.<sup>149</sup>

Although the Supreme Court of Appeal in the *NWK* case based its decision on the statement that transactions that have a sole purpose of evading tax should be regarded as simulated, the court did not prove or establish NWK's purpose to evade tax. The Supreme Court of Appeal in essence applied the principle stated in the *Zandberg* case to determine simulation in the *NWK* case. The court considered the relevant facts and circumstances in the *NWK* case to determine NWK's intention and the true nature of the R96 million loan agreement. The court took into account the process of *confusio* which extinguished NWK's obligation to deliver maize which in effect was payment of the R96 million loan, the inconsistencies of NWK's witness and the lack of security for the R96 million loan to determine NWK's intention. These factors along with Barnard's admission that NWK only required R50 million from FNB<sup>150</sup> indicated that NWK's intention was to conclude a loan for R50 million.

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<sup>143</sup> Ibid.

<sup>144</sup> Ibid para 80.

<sup>145</sup> Ibid para 89.

<sup>146</sup> Ibid.

<sup>147</sup> Ibid.

<sup>148</sup> Ibid para 94.

<sup>149</sup> 58 of 1962.

<sup>150</sup> Ibid para 54.

Emslie is of the opinion that the court's conclusions in the *NWK* case 'fall squarely in the ambit'<sup>151</sup> of the simulation test expressed in the *Zandberg* and *Randle Brothers* cases.<sup>152</sup> He states that the extinction of *NWK*'s obligation to deliver maize by the process of *confusio* and Barnard's<sup>153</sup> knowledge of the cumulative effect of loan transactions rendered the R96 million loan agreement a sham.<sup>154</sup> The parties to the loan agreement never intended actual delivery of maize to take place.<sup>155</sup> For this reason Emslie concludes that the extension of the traditional simulation test by the Supreme Court of Appeal in the *NWK* case was *obiter* and not binding in law.<sup>156</sup>

### 3 5 The Court's Justification for Extending the Traditional Simulation Test

It can be inferred from the *NWK* judgment that Lewis JA's reason for extending the traditional simulation test was that there is 'divergence' in the application of the principles stated in the *Zandberg* case and *Randles Brothers* case<sup>157</sup> because 'the cases do not consistently approach what is really meant by a party's intention in concluding a contract – what purpose he or she seeks to achieve'.<sup>158</sup> Illustrating the courts' inconsistencies to determine/ ascertain the intention of parties to agreements, Lewis JA referred to the *Randles Brothers* case, where the court used different approaches/ methods to determine the intention of Randles Brothers & Hudson (Pty) Ltd.<sup>159</sup> The facts of the case are stated below.

Randles Brothers & Hudson (Pty) Ltd was a registered importer of fabric under the 1934 Customs Regulations and it was entitled to claim customs rebates for any goods it imported from manufacturers. In 1936, a new Customs Excise Act was enacted and Randles could only claim customs rebates if it transferred ownership of the fabric to the manufactures. Randles took advantage of the new Customs

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<sup>151</sup>Trevor Emslie 'Simulated Transactions – A New Approach' (2011) 60 6.

<sup>152</sup> *Ibid.*

<sup>153</sup> *NWK*'s witness.

<sup>154</sup> Emslie op cit note 151 at 5-6.

<sup>155</sup> *Ibid.*

<sup>156</sup> *Ibid* at 6.

<sup>157</sup> *NWK* supra note 1 at para 43 – 45 , In the *Zandberg* case the court emphasized the point that a simulated transaction has an element of pretence and that determining the intention of parties to an agreement involves a factual of a case and in the *Randle Brothers* case the court stressed that an agreement is not necessarily simulated if it is created for the purpose of 'evading a prohibition of law or avoiding liability for tax imposed by it', such a transaction should be interpreted by the court according to its tenor.

<sup>158</sup> *NWK* supra note 1 at para 45.

<sup>159</sup> *Ibid* 47-48.

Regulations and it altered its practice with manufactures and entered into sale agreements with the manufacturers. Randles did all this, in order to claim customs rebates. The Commissioner argued that Randles had circumvented the law and contended that the transactions were *in fraudem legis*.<sup>160</sup> Watermayer JA for the majority held that Randles' intended to transfer ownership of the materials to the manufacturers and stated that the sales were a vehicle to achieve its intent.<sup>161</sup> De Wet CJ and Tindall JA found there was no genuine sale because there was no genuine price to the sale agreements<sup>162</sup> and no intention to take ownership of the goods on the part of the manufacturers<sup>163</sup> and held that Randles was liable to pay customs duty.<sup>164</sup>

The main dispute in the case was the authenticity of Randles intention to transfer ownership of the materials to the manufacturers. According to Lewis JA , Watermayer JA looked at Randles state of mind<sup>165</sup> to determine its intention to transfer ownership of the materials to the manufacturers and Tindall JA preferred to look at 'what was done rather than what was said'<sup>166</sup> to determine Randles' intention to transfer ownership of the materials to the manufacturers.<sup>167</sup> Other authors distinguish Watermayer JA and De Wet JA methods to determine intention – the former as using a subjective approach<sup>168</sup> to determine intention and the latter as using an objective approach<sup>169</sup> to determine intention.<sup>170</sup>

Lewis JA further substantiated the contention that cases/courts have not consistently determined the intention of parties in concluding an agreement. Lewis JA stated that in *Vasco Dry Cleaners V Twycross*<sup>171</sup> and *Skeljbrede Rederi A/S V Hartless*<sup>172</sup> the judges adopted the minority approach in the *Randles Brothers* case<sup>173</sup>

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<sup>160</sup> *Randle Brothers* supra note 13 at p49 of 33 SATC 48 , the use of the words *in fraudem legis* means in fraud of law , but in the Randles Brothers case the phrase connotes a simulated transaction.

<sup>161</sup> Avoiding customs duty and transferring ownership of the materials to the manufacturers.

<sup>162</sup> Tindall JA in the *Randles Brothers* case at p76 of 33 SATC 48.

<sup>163</sup> De Wet CJ in the *Randles Brothers* case at p62 of SATC 48.

<sup>164</sup> De Wet CJ in the *Randles Brothers* case at p62 of SATC 48.

<sup>165</sup> Watermayer JA in the Randles Brothers case conducted an inquiry of Randles intention to deceive the Customs Officials at p71 of 33 SATC SATC 48.

<sup>166</sup> *NWK* supra note 1 para 48

<sup>167</sup> *Ibid* at para 47-48.

<sup>168</sup> Looking at the state of mind or true intent of parties to determine intention / an intention to deceive.

<sup>169</sup> Looking at the circumstances prior the conclusion of the sale agreement to determine intention.

<sup>170</sup> *Emslie* op cit note 151 at 4.

<sup>171</sup> 1979 (1) SA 603(A).

<sup>172</sup> 1982 (2) SA 710(A).

<sup>173</sup> What is done is more important than what is said.

to determine intention whilst in *Hippo Quarries (Tvl) (Pty) Ltd V Eardly*<sup>174</sup> the court accepted the form of a transaction as reflecting the intention of the parties to the agreements.<sup>175</sup>

Vorster contends that the distinction between the two judgments in the *Randle Brothers* case was not one of principle<sup>176</sup> but rests in the conclusions made by the judges when they examined the facts of the *Randles Brothers* case to determine the intention of the parties to the sale agreements.<sup>177</sup> In support of his argument, he states that both judges in the *Randles Brothers* case accepted the principle stated in the *Zandberg* case<sup>178</sup> and accepted the fact that parties were permitted to organise their 'affairs so as to avoid customs duty'.<sup>179</sup> He is of the opinion that the judges in the *Randles Brothers* case considered all the relevant circumstances to determine Randles intention.<sup>180</sup> Vorster's opinion is correct, in the *Randles Brothers* case De Wet CJ and Watermeyer JA both considered the facts and circumstances of the case to determine Randles intention in concluding contracts of sale.<sup>181</sup>

In all the cases that Lewis JA distinguished, the judges looked at all the relevant facts and circumstances of a case to determine the true intention of parties in entering into an agreement. In the *Vasco Dry Cleaners* case the court considered the evidence of the parties and the cumulative effect of the sale and resale agreements to determine the intention of the parties in concluding the agreements.<sup>182</sup> In the *Hippo Quarries* case the court accepted that determining the true intention of parties to an agreement involves a factual inquiry of a case<sup>183</sup> and looked at the Hippo Companies' reasons for concluding a cession agreement to determine the true intention of the parties to the agreements.<sup>184</sup> In the *Skjelbreds* case the court also accepted that the test to determine intention involves a consideration of all the facts of a case<sup>185</sup> and the court looked at what the parties sought to achieve by entering

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<sup>174</sup> 1992 (1) SA 867 (A).

<sup>175</sup> *NWK* supra note 1 at para 49-50.

<sup>176</sup> Henry Voster 'NWK AND PURPOSE AS A TEST FOR SIMULATION' *The Taxpayer Journal* (2011) 60 85.

<sup>177</sup> *Ibid* 84.

<sup>178</sup> *Ibid* 84, De Wet CJ at 57 of 33 SATC 48; Watermeyer JA 66 of 33 SATC 48.

<sup>179</sup> Voster op cit note 176 at 85, De Wet CJ in *Randles Brothers* supra note 13 at 33 SATC 56 ; Watermeyer JA in *Randles Brothers* supra note 13 at 33 SATC 66-7.

<sup>180</sup> Voster op cit note 176 at 85.

<sup>181</sup> *Randles Brothers* supra note 13 at 62 & 72 of 33 SATC 48.

<sup>182</sup> *Vasco Dry Cleaners V Twycross* 1979 (1) 603 (A) at p 604 & 620.

<sup>183</sup> *Hippo Quarries Transvaal (Pty) Ltd V Eardly* 1976 (4) 726 (D) at p17.

<sup>184</sup> *Ibid* at p3.

<sup>185</sup> *Skjelbreds Rederi A/S V Hartless (Pty) Ltd* 1982 (2) SA 710 (A) at p271 D-H.

into agreements of cession and the inconsistencies in the implementation of the cession agreement to determine the true intention of the parties in concluding a cession agreement.<sup>186</sup> In all the cases that Lewis JA distinguished as using different approaches to determine intention, the courts looked at the entire circumstances of each case to determine a party's/ parties intention in concluding an agreement.

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<sup>186</sup> *Skjelbreds Rederi A/S V Hartless (Pty) Ltd* 1982 (2) SA 710 (A) at p172 & 735.

#### 4 Analysis of the NWK Simulation Test

Some commentators are of the view that the Supreme Court of Appeal created a new rule/test to determine simulation,<sup>187</sup> that is contrary to established principles in the law relating to simulated transactions<sup>188</sup> whilst other commentators are of the opinion that the simulation test formulated in the *NWK* case should be interpreted as part of the precedent<sup>189</sup>. The purpose of this chapter is to analyse the simulation test formulated in the *NWK* case and to determine if the Supreme Court of Appeal in the *NWK* case changed the concept of simulation in South Africa. This chapter will also discuss the correctness of the extended simulation test formulated in the *NWK* case and state the repercussions of the *NWK* judgment. The different parts/segments of the simulation test formulated in the *NWK* will be analysed separately.

##### 4.1 'Examination of the Commercial Sense of a Transaction'

The Supreme Court of Appeal in the *NWK* case seems to have drawn the commerciality requirement from the *Conhage* and *Friedman* cases. In the *Friedman* case, parties had a commercial reason or purpose for entering into agreements of sale and resale. The parties in the *Friedman* case were had to provide a warranty for the money that the Bank had made available to the parties.<sup>190</sup> In the *Conhage* case, sale and leaseback agreements of industrial tools enabled the manufacturer to remain in control of the tools.<sup>191</sup> In the *NWK* case the court could not find a commercial purpose for the structure of the R96 million loan agreement, 'other than creating a tax advantage for NWK'.<sup>192</sup> NWK could not provide a commercial reason for entering into the structured loan agreement of R96 million.

One can interpret the commerciality requirement stated in the *NWK* case to imply that if a taxpayer is unable to provide a credible explanation for a lack of commercial substance in an income tax context; such a transaction will be simulated.<sup>193</sup> The onus would rest on the taxpayer to prove the commerciality of the

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<sup>187</sup> Eddie Bromberg 'NWK AND FOUNDERS HILL' *The Taxpayer Journal* (2011) 60 197 & 201.

<sup>188</sup> *Ibid.*

<sup>189</sup> Judge Dennis Davis' opinion of the interpretation of the *NWK* simulation test as stated in the case of *Bosch and Another V Commissioner of South African Revenue Services* (A94/2012) [2012] ZAWCHC 188.

<sup>190</sup> *NWK* supra note 1 at para 54.

<sup>191</sup> *Ibid* para 54.

<sup>192</sup> *NWK* supra note 1 at para 57-58.

<sup>193</sup> De Koker & Williams op cit note 20 at para 19.3.

transaction.<sup>194</sup> This interpretation is in line with the case of *ITC 1636* also known as the *Conhage* case on Appeal, where a taxpayer had to provide commercial reasons for entering into agreements sale and leaseback to prove its true intention and to show that the transactions were not simulated.<sup>195</sup> Some authors are of the opinion that the commerciality requirement introduced in the extended simulation test should only have evidentiary relevance and should not be regarded as a substantive criterion of the test to determine simulation.<sup>196</sup> This implies that the test to determine simulation has not changed as the commercial substance of transaction should only be of evidentiary value when determining simulation.

De Koker & Williams highlight that the ordinary meaning of the word simulation connotes pretence or a feigned transaction.<sup>197</sup> They state that the Supreme Court of Appeal in the *NWK* case used the word simulated to connote a transaction that is not disguised but which lacks commercial substance and which does not make business sense and this parts meaning with the ordinary meaning of the word 'simulated'.<sup>198</sup> The only way in which the word 'simulated' as used in the *NWK* case, would make sense is if the lack of commercial substance in a transaction is regarded as an indicator or symptom that a transaction is pretence or disguise.<sup>199</sup>

#### **4 2 'If the Purpose of a transaction is only to achieve an object that allows the evasion of tax, or a peremptory law, then it will be regarded as simulated'**

The court in the *NWK* case seems to have wrongly considered simulation to be tax evasion. Vorster states that the simulation/ substance over form doctrine involves a process of determining the true intention of parties to a transaction<sup>200</sup> whilst tax evasion is an unlawful and criminal act in South African Tax Law.<sup>201</sup> A transaction that evades or has the purpose of evading tax is considered to be an act of tax evasion and is illegal.<sup>202</sup> An illustration of tax evasion is where a taxpayer does not reveal all his income, in his yearly tax return. The taxpayer pays a reduced amount of tax, than the actual amount of tax he is supposed to pay, when he conceals information from

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<sup>194</sup> Ibid.

<sup>195</sup> *ITC 1636* 60 SATC at p314 &394.

<sup>196</sup> Ibid.

<sup>197</sup> De Koker & Williams op cit note 20 at para 19.3.

<sup>198</sup> Ibid.

<sup>199</sup> Ibid, *CIR V Conhage Pty Ltd* 1999 (4) 1149 (SCA).

<sup>200</sup> Vorster op cit note 176 at 83.

<sup>201</sup> S104 (1) of the Income Tax Act 58 of 1962

<sup>202</sup> ibid

revenue authorities.<sup>203</sup> Tax evasion cannot be equated or substituted by simulation because they are different concepts in South African Tax Law.

Although the court in the *NWK* case made the assertion that transactions that have a sole purpose of evading tax should be regarded as simulated, the court did not prove *NWK*'s purpose to evade tax. Tax evasion in the *NWK* case occurred as a result of *NWK*'s misrepresentation in its income tax returns. *NWK* had stated that the payment of the promissory notes were in respect of interest, when they were also in respect of capital.<sup>204</sup>

Emslie states that the court meant to use the word avoidance in place of the word evasion when it made the proposition that a transaction that has the object of evading tax should be regarded as simulated.<sup>205</sup> He also suggests that the court's proposition would still have remained 'illogical',<sup>206</sup> had the extended simulation test read that transactions which have the object of avoiding tax should be regarded as simulated.

In *Bosch V Commissioner for the South African Revenue Services*<sup>207</sup>, the CSARS<sup>208</sup> relied on the *NWK* simulation test to challenge the authenticity of sale and resale provisions in an 'employee share incentive deferred delivery scheme'.<sup>209</sup> Judge Dennis Davis clarified the interpretation of the *NWK* simulation test and he seems to adopt the view that the Supreme Court of Appeal in the *NWK* case, meant to use the word avoidance in place of the word evasion; when it made the proposition that transactions that have a purpose of evading tax should be regarded as simulated.

He interprets the *NWK* simulation test to that mean, that if a transaction in substance lacks commercial sense and the form of the transaction reflects its commerciality, 'then the avoidance of tax as the sole purpose of the transaction would present a powerful justification for approaching the set of transactions in the manner undertaken by the court in the *NWK* case'.<sup>210</sup> He is of the opinion that such an interpretation would be a reasonable explanation of the *NWK* simulation test.<sup>211</sup>

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<sup>203</sup> OECD Tax Glossary of Terms available at <http://www.oecd.org/ctp/glossaryoftaxterms.htm#T> accessed on 21 August 2013

<sup>204</sup> *NWK* para 34

<sup>205</sup> Emslie op cit note 26 at 24.

<sup>206</sup> *Ibid.*

<sup>207</sup> (A94/2012) [2012] ZAWCHC 188

<sup>208</sup> Commissioner for South African Revenue Services

<sup>209</sup> *Bosch* supra note 189 at para 2

<sup>210</sup> *Bosch* supra note 189 at para 86.

<sup>211</sup> *Ibid.*

He further states that a court would still have to ascertain, if parties to an agreement had an unexpressed agreement before concluding that a transaction is simulated.<sup>212</sup> Judge Davis views the NWK simulation test as merely an extension of the traditional simulation test. He also states that the NWK simulation test should not be read as changing the law on simulated transactions because the court in *NWK* case did not expressly rule out or replace established principles on simulated transactions. He is of the view that the simulation test formulated in the *NWK* case should be interpreted as part of precedent.<sup>213</sup>

Judge Davis based his opinion on the case of *Ladysmith* case where taxpayers (the Ladysmith Companies) and its affiliated companies entered into agreements of lease and sublease with a Pension Fund in order to avoid accrual of gross income in the hands of the taxpayers. The face of the lease agreement indicated that the taxpayers had not accrued gross income in terms of par (h) of S1 of the Income Tax Act,<sup>214</sup> the court questioned the commercial rationale of the inclusion of a Pension Fund in affiliated parties' arrangements<sup>215</sup> to establish the purpose of the parties in concluding agreements of lease and sublease. The court also analysed the lease and sub-lease agreements and had regard to 'what the parties sought to achieve'<sup>216</sup> by entering into agreements of lease<sup>217</sup> and found that the taxpayers had accrued gross income in terms of para (h) of S1 of the Income Tax Act.<sup>218</sup> The court also ruled that the lease agreements did not reflect the real intention of the parties because the differences in the lease and sublease agreements indicated that there was a possibility that there was an unexpressed agreement between the parties to the lease agreements.<sup>219</sup> The importance of the *Ladysmith* case is that even when an agreement is concluded for the purpose of avoiding tax, such an agreement cannot be said to be simulated, without ascertaining an expressed agreement between parties to an agreement.

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<sup>212</sup> Ibid.

<sup>213</sup> Ibid.

<sup>214</sup> 58 of 1962, par(h) of S1 of the Income Tax Act considers the accrual of a right to have improvements on land as part of the gross income. The right to have improvements has to be quantified.

<sup>215</sup> *Ladysmith* supra note 10 at p8 & 29.

<sup>216</sup> Ibid at p9 & 26.

<sup>217</sup> Ibid at p26.

<sup>218</sup> 58 of 1962.

<sup>219</sup> Ibid at p33.

Bromberg highlights that when parties conclude a transaction with the object of avoiding tax, their transaction cannot be regarded as simulated if the parties genuinely intended to perform the transaction according to its terms.<sup>220</sup> This principle was stated in the *Randle Brothers* case and has been firmly established in South Africa.<sup>221</sup> Bromberg seems to assume that the Supreme Court Appeal in the *NWK* case, meant to use the word avoidance when it made the proposition that transactions that have a sole purpose of evading tax should be regarded as simulated. He views the *NWK* simulation test as a new rule, which has changed the concept of simulation in South Africa.<sup>222</sup>

Even though the simulation test formulated in the *NWK* judgment states that transactions that have a sole purpose of evading tax are simulated, it is a settled principle of law, that if parties conclude an agreement for unlawful purposes, the agreement will not be enforceable or recognized in law even if the parties intention to the agreement is genuine.<sup>223</sup> Once a court determines that a taxpayer has concluded a transaction which has unlawful purpose, such as the evasion of tax, a court should not recognize such an agreement. The Commissioner can then assess the taxpayer on his actual income without resorting to Income Tax legislation.<sup>224</sup> The inquiry of whether an agreement is simulated then becomes unnecessary.

#### **4 3‘Performance is a Charade’**

The Supreme Court of Appeal in the *NWK* case stated that performance of an agreement does not prove or show that it is not simulated.<sup>225</sup> The court further stated that the ‘charade of performance is generally meant to give credence to their simulation’.<sup>226</sup> The court reached this decision after considering the constructive delivery and counter delivery of maize between the parties to the *NWK* loan agreement. Performance of the terms of the *NWK* loan agreement resulted in

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<sup>220</sup> Bromberg op cit note 187 at 205.

<sup>221</sup> The cases of *Maize Board V Jackson* 2003 (6) 592 (SCA) and *Michau V Maize Board* 2003(6) SA 459 (SCA) concerned the legitimacy of lease and management agreements, the court in these cases also stated that a purpose to avoid levies or tax is not an adequate premise to substantiate a claim that a transaction is simulated.

<sup>222</sup> Bromberg op cit note 187 at 197-198 &202.

<sup>223</sup> *Hippo Quarries (Transvaal ) Pty Ltd V Eardly* (1992) (1) SA 876 at p19.

<sup>224</sup> R C Williams ‘Income Tax in South Africa – Law and Practice’ 4ed (2006) 773.

<sup>225</sup> *NWK* supra note 1 at para 55.

<sup>226</sup> *Ibid.*

*confusio* and this extinguished NWK's obligation to deliver maize.<sup>227</sup> The court found that the parties to the NWK loan agreement never intended to deliver maize in the future and held that the agreements in respect of maize were 'illusory'.<sup>228</sup>

The proposition that performance of an agreement does not prove that a transaction is not simulated was upheld in the case of *Relier V Commissioner of Inland Revenue*.<sup>229</sup> In this case, parties had performed lease and sublease agreements but the court found that there was an unexpressed agreement between the parties to the lease and sublease agreements.<sup>230</sup> The court in the *Relier* case held that the lease and sublease agreements were simulated, regardless of the parties performance of the agreements. When determining simulation, the point of inquiry is always 'whether parties intended to give effect to their agreement according to its terms'<sup>231</sup> and not whether parties performed an agreement according to its terms. The court in the *NWK* case was correct when it asserted that performance of an agreement does not prove or show that a transaction is not simulated.

One can interpret the extended simulation test formulated in the *NWK* case to imply that courts should determine the intention of parties to an agreement as well as purpose of transaction to determine simulation, and if the sole purpose of a transaction is to evade tax such a transaction should be regarded as simulated. This would be a broader test to determine simulation which seeks to categorize unlawful or illegal transactions as simulated and this test would be different from the traditional test used to determine simulation. Interpreted in its totality the extended simulated test can be interpreted as changing the test to determine simulation in South Africa. Fortunately, various authors<sup>232</sup> have stated that the extension of the traditional simulation test by the Supreme Court of Appeal Court in the *NWK* case was *obiter*,<sup>233</sup> thus the *NWK* judgment has not changed the traditional test used to determine simulation in South Africa. The Court in the *NWK* case also did not explicitly rule out or substitute established principles in the law relating to simulated

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<sup>227</sup> *Ibid* para 75.

<sup>228</sup> *Ibid* para 89.

<sup>229</sup> 1997 60 SATC 1.

<sup>230</sup> *Relier V Commissioner for Inland Revenue* 1997 60 SATC 1 at p14.

<sup>231</sup> *Zandberg* supra note 13 at 309.

<sup>232</sup> Emslie op cit note 26 at 23 , De Koker & Williams op cit not 20 at para 19.3, Broomberg op cit note 187 at 206.

<sup>233</sup> Emslie op cit note 26 at 23 , De Koker & Williams op cit not 20 at para 19.3, Broomberg op cit not 187 at 206 , Vorster op cit note 176 at 85.

transactions,<sup>234</sup> hence the NWK judgment has not changed the concept of simulation in South African Law.

#### **4 4 The Effect of the NWK Simulation Test on Future Case Law and Income Tax Law in South Africa**

The simulation test formulated in the *NWK* case is similar to S80A (a) (ii) of the Income Tax Act.<sup>235</sup> In instances where taxpayers enter into genuine transactions that have the purpose of avoiding tax and the transaction lacks commercial substance, assessors can choose to apply the NWK simulation test and others can invoke S80A(a)(ii) of the Income Tax Act along with the other general anti-avoidance provisions to the transaction.<sup>236</sup> In terms of the NWK simulation test, if a transaction lacks commercial substance and also has the purpose of evading tax, such a transaction can be regarded as simulated and the parties to such a transaction might find themselves subject to adverse tax consequences.<sup>237</sup>

Legwaila is of the opinion that the NWK simulation test expands the substance over form doctrine.<sup>238</sup> He states that a transaction should now have legal substance and commercial substance to pass the NWK simulation test.<sup>239</sup> He also states that the extended simulation test in the *NWK* case modernises the substance over form doctrine,<sup>240</sup> he believes that the test is a necessary advancement of the traditional simulation principle as it helps courts and the Revenue Authorities to eliminate the mischief of tax evasion.<sup>241</sup> He also states that the extended simulation test is an affirmation of the position that performing an agreement according to its terms is not a guarantee that it is not simulated.<sup>242</sup>

The NWK extended simulation test widens the scope of common law in South Africa.<sup>243</sup> Olivier highlights that it is usually difficult for the Commissioner to

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<sup>234</sup> Judge Davis opinion in *Bosch and Another V Commissioner of South African Revenue Services* (A94/2012) [2012] ZAWCHC 188 para 86.

<sup>235</sup> 58 of 1962, The section suggests that An avoidance arrangement that solely has the object of obtaining a tax benefit in the context of business and lacks commercial substance is regarded as an impermissible avoidance arrangement.

<sup>236</sup> 58 of 1962.

<sup>237</sup> De Koker & Williams op cit note 20 at para 19.3.

<sup>238</sup> Legwaila op cit note 23 at 121.

<sup>239</sup> Ibid.

<sup>240</sup> Legwaila op cit note 23 at 127.

<sup>241</sup> Ibid.

<sup>242</sup> Ibid.

<sup>243</sup> Ibid at 126.

succeed in cases of tax avoidance on the basis of statutory provisions,<sup>244</sup> S103 and S80A of the Income Tax Act, as taxpayers arrange or structure their agreements in such a way that one of the prerequisites of the anti-avoidance statutory provisions is not met.<sup>245</sup> The effect of the *NWK* case is that the Commissioner might end up resorting to common law to solve cases of tax avoidance.

Vorster is of the opinion that the test formulated in the *NWK* case should be utilized only in cases which have similar facts and agreements to those in the *NWK* case,<sup>246</sup> because the reasoning of the Supreme Court of Appeal in the *NWK* case is peculiar to the unusual facts of the *NWK* case.<sup>247</sup> Some commentators are of the view that the *NWK* case can only serve as precedent where evasion is in issue,<sup>248</sup> and state that the judgment cannot serve as precedent binding on lower courts because of the confusion created by the judgment.<sup>249</sup>

Emslie suggests that taxpayers should now make sure that their transactions have 'commercial sense' and 'real substance'.<sup>250</sup> He advises taxpayers to explicitly state the commercial sense and the real substance of their agreements in the foreword of their contracts.<sup>251</sup> Olivier believes that the significance of the *NWK* case is that tax avoidance schemes can be challenged in terms of common law and this is often ignored by taxpayers and tax consultants.<sup>252</sup> Olivier's contention is true because tax avoidance schemes can be challenged in terms of the common law simulation test i.e. the substance over form doctrine.

#### **4 5 Repercussions of the NWK Judgment**

After the *NWK* judgment the SARS<sup>253</sup> stated in its media release in 2010, that many taxpayers had entered into simulated transactions such as the one in the *NWK* case and that it would commence an audit of taxpayers.<sup>254</sup> The SARS<sup>255</sup> called all

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<sup>244</sup> Olivier & Honiball op cit note 2 at 516. Olivier seems to the court meant to use the word avoidance when it stated that transactions that have sole purpose to evade tax should be regarded as simulated.

<sup>245</sup> Ibid at 125.

<sup>246</sup> Vorster op cit note 176 at 85.

<sup>247</sup> Ibid.

<sup>248</sup> *Bosch* supra note 189 at para 9

<sup>249</sup> Ibid.

<sup>250</sup> Emslie op cit note 151 at 7.

<sup>251</sup> Ibid.

<sup>252</sup> Olivier & Honiball op cit note 2 at 516.

<sup>253</sup> South African Revenue Authority.

<sup>254</sup> SARS Media Release 2010 available at

<http://www.sars.gov.za/AllDocs/Documents/MediaReleases/2010/SARS-MR-2010-058%20->

taxpayers to utilise the ‘Voluntary Disclosure Programme’ before the commencement audits.<sup>256</sup> The tax authority stated that taxpayers that do not use the programme will be subject to additional tax and interest.<sup>257</sup> Some authors are of the opinion that SARS<sup>258</sup> reaction to the *NWK* case was entirely unnecessary as it appears to be centered on the understanding that all structured finance facilities constitute simulated transactions and this cannot be.<sup>259</sup>

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*%20Media%20release%20on%20Supreme%20Court%20of%20Appeal%20Judgment%20-%202015%20December%202010.pdf* accessed on 5 August 2013.

<sup>255</sup> South African Revenue Services Authorities.

<sup>256</sup> *Ibid.*

<sup>257</sup> *Ibid.*

<sup>258</sup> South African Revenue Services

<sup>259</sup> B Ger ‘*Supreme Court of Appeal a- maize tax planners with watershed judgment*’ Derebus 2011 available at

[http://www.myvirtualpaper.com/doc/derebus/de\\_rebus\\_april\\_2011/2011032301/45.html#46](http://www.myvirtualpaper.com/doc/derebus/de_rebus_april_2011/2011032301/45.html#46) accessed on 7 August 2013.

## 5 Conclusion

The extended simulation test formulated in the *NWK* judgment interpreted in its totality without replacement of words implies that courts have to determine the intention of parties to a transaction and the purpose of a transaction to determine simulation. If the sole purpose of a transaction is to evade tax, such a transaction will be regarded as simulated.<sup>260</sup> The extended simulation test formulated in the *NWK* case can be interpreted as changing the traditional test used to determine simulation.

Fortunately, various authors have stated that the extension of the traditional simulation test in the *NWK* case was *obiter*; hence the *NWK* judgment has not changed the test to determine simulation in South African Law. The commerciality requirement stated in the *NWK* judgment was already part of the test to determine simulation, and this is evidenced in *ITC 1636* reported on Appeal as the *Conhage* case. The Supreme Court of Appeal in the *NWK* case correctly held that performance of an agreement does not prove or show that agreement is not simulated. The test to determine simulation focuses on the intention of parties in concluding an agreement and not on parties' performance of an agreement.

Although some authors state that the Supreme Court of Appeal in the *NWK* case created a new test to determine simulation, the traditional simulation test stated in the *Zandberg* and *Randles Brothers* cases still stands. The traditional test to determine simulation is in essence, a test to determine the true intention of parties of parties to an agreement and courts consider all the entire circumstances of case to determine intention.<sup>261</sup> As suggested by Emslie, taxpayers now have to state the 'real substance' and commercial reasons for their transactions<sup>262</sup> to ensure that their transactions will not be regarded as simulated

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<sup>260</sup> *NWK* supra note 1 at para 55.

<sup>261</sup> *Zandberg* supra note 13 at 302, *ITC 1185* [1972] 35 SATC 122, *Michau* supra note 55 at para 4, *Jackson* supra note 55 at para 7.

<sup>262</sup> Emslie op cit note 151 at 7.

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